United States Court of Appeals

for the Second Circuit

APPENDIX

ORIGINAL

75-7503

United States Court of Appeals

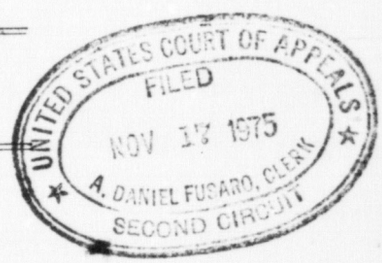
For the Second Circuit.

SUSAN TANNENBAUM,
Plaintiff-Appellant,

against

ROBERT G. ZELLER, *et al.*,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK.



JOINT APPENDIX.

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THE REPORTER COMPANY, INC., New York, N. Y. 10007—212 732-6978—1975

(7621)

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UNITED STATES COURT OF APPEALS,

FOR THE SECOND CIRCUIT.

Docket No. 75-7503

- -X

SUSAN TANNENBAUM,
Plaintiff-Appellant,

-against-

ROBERT G. ZELLER, *et al.*,
Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

- -X

RELEVANT DOCKET ENTRIES

5/11/71	Complaint filed and Summons issued.
9/24/71	Answer to Complaint of defendants F. Eberstadt & Co., Inc., F. Eberstadt & Co. Managers and Distributors, Inc., and Robert G. Zeller filed.
10/8/71	Answer to Complaint of defendant Chemical Fund, Inc., filed.
10/2/74	Pre-trial Order filed.
12/17/74	Order of voluntary dismissal without prejudice filed as to all defendants other than defendants F. Eberstadt & Co., Inc., F. Eberstadt & Co. Managers and Distributors, Inc., and Robert G. Zeller.
12/16/74-12/18/74	Trial without a jury before Hon. Robert L. Carter
7/30/75	Opinion of Hon. Robert L. Carter dismissing Complaint filed.
8/1/75	Judgment dismissing Complaint as against defendants F. Eberstadt & Co., Inc., F. Eberstadt & Co. Managers and Distributors, Inc., and Robert G. Zeller filed.
8/27/75	Plaintiff's Notice of Appeal filed.

COMPLAINT.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- X

SUSAN TANNENBAUM,

Plaintiff,

-against-

ROBERT G. ZELLER, FRANCIS S. WILLIAMS, ROBERT C. PORTER, JAMES S. COLES, BURT N. DORSETT, JULIAN M. AVERY, ALFRED E. DRISCOLL, ANDREW W. EBERSTADT, WHITMAN HOBBS, LEROY F. MAREK, JAMES J. MINOT, ROGER F. MURRAY, AUGUSTE RICHARD, BERTRAND FOX, HOWARD A. RUSK, F. SCHNEIDER, ESTATE OF F. EBERSTADT, F. EBERSTADT & CO., INC., F. EBERSTADT & CO. MANAGERS AND DISTRIBUTORS, INC. and CHEMICAL FUND, INC.,

Defendants.

COMPLAINT

- X

Plaintiff alleges on information and belief, except paragraph "1" which plaintiff alleges upon knowledge:

FIRST CAUSE OF ACTION

1. Plaintiff owns shares of Chemical Fund, Inc. (the "Fund") and has owned Fund shares continuously since prior to the time of the transactions alleged.

2. (a) Plaintiff brings this action derivatively on behalf, in the right and for the benefit of the Fund.

(b) This action is not collusive to confer on this Court jurisdiction it does not otherwise have.

COMPLAINT

3. Jurisdiction is under the Investment Company Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934 and rules and regulations under each (collectively hereinafter called the "Acts"). Defendants' acts alleged constitute violations of the Acts.

4. (a) The Fund is a Delaware corporation organized in 1938. It has authorized approximately 35 million shares, of which there are outstanding some 31 million shares owned by about 67,000 shareholders.

(b) The Fund had net assets of about $532 million, at December 31, 1970, which assets have since increased.

(c) The Fund's activities are conducted through use of mails and instrumentalities of interstate commerce.

5. The Fund is registered under the Investment Company Act of 1940 as an open-end diversified investment company, known as a mutual fund. Its offices are at 61 [illegible]-way, in the Southern District of New York.

6. F. Eberstadt & Co. Managers & Distributors, Inc. ("Adviser") is a Delaware corporation with offices in New York City and acts as both adviser and distributor for the Fund. Adviser's stock is wholly owned by F. Eberstadt & Co., Inc., a New York corporation that succeeded to F. Eberstadt & Co. November 1, 1969.

7. At all material times herein, the directors of the Fund were Messrs. F. Eberstadt (now deceased), Williams,

Porter, Coles, Dorsett, Avery, Driscoll, A. W. Eberstadt, Hobbs, Marek, Minot (until 1970), Murray, Richard, Rusk, Fox (since 1970), Schneider and Zeller.

8. The Fund employs the Adviser, pursuant to written agreement ("Agreement") whereby Adviser furnishes the Fund with various services including research, statistical and advisory services. Prior to April 1, 1970, the Fund paid the Adviser a quarterly management fee based upon the average daily net assets of the Fund. The management fees (excluding payments to non-affiliated directors) for 1965, 1966, 1967, 1968 and 1969 were respectively $1,160,563, $1,268,590, $1,428,228, $1,505,231 and $1,521,868. In or about March 1970, defendants presented to Fund shareholders a new management agreement which included a revised schedule of fees to the Adviser based upon revised criteria, including relationship of performance by the Fund compared against a Standard & Poor Industrial Index. Pursuant to such formula, the 1970 management fee was $1,662,203; had such new formula been in effect from 1960 to 1969, the management fees paid by the Fund to the Adviser would have been increased by a total of $2,392,000.

9. The Adviser also makes sales agreements with dealers at discount from offering prices at prices based on the net asset value of Fund shares. Gross sales commissions paid by shareholders range from 8.5% on smaller sales to 0.5% on sales over $1,000,000. For the year ended 1966, 1967, 1968,

1969 and 1970, gross sales commissions paid the Adviser were $2,126,000, $1,599,000, $1,441,000, $1,328,000 and $2,099,000, respectively.

10. By means of the foregoing, the Adviser earns large fees and commissions from management and control of the Fund, as well as from its simultaneous performance of like functions for the Eberstadt Fund, Inc., which the Adviser also manages and controls; further income is derived from business conducted by its parent, F. Eberstadt & Co., Inc.

11. The Adviser exercises de facto control over the Fund and fixes and determines the Fund policies and activities. Pursuant thereto, defendants caused the Fund to purchase and sell numerous portfolio securities. The Fund is a source of large brokerage commissions for brokers and dealers who execute purchases and sales of securities ("portfolio transactions") on and outside of the national securities exchanges.

12. To enable the Adviser to benefit itself and other defendants and to increase the Adviser's fees and profits from the Fund, the Adviser used its control of the Fund to eliminate any possibility that the Fund might benefit from its own brokerage business by utilizing various methods of reducing brokerage commissions paid by the Fund. The Adviser caused the Fund to pay the largest brokerage commissions for portfolio transactions, to benefit the Adviser and to require executing brokers to pay portions of their commissions to other brokers and dealers

who sell Fund shares or supply services and materials to the Adviser or its parent. Thus the Adviser indirectly received increased management fees, as well as other services and materials.

13. For the years 1966, 1967, 1968 and 1969, brokerage commissions paid by the Fund on portfolio transactions amounted to $447,653, $617,787, $501,604 and $472,771, respectively.

14. The Fund's prospectuses and proxy statements state that for 1966, $379,752 of the commissions were allocated to dealers as an additional reward for the sale of Fund shares and $42,900 was allocated to dealers who provided statistical research information to the Adviser. The figures for 1967 were $510,346 and $61,000; for 1968, $430,150 and $45,967; and for 1969, $363,036 and $46,454.

15. As a result of defendants' above acts, the Fund has been deprived of substantial benefits. Such allocations of commissions constitute an illegal rebate to dealers, and an additional, unlawful benefit to the Adviser.

16. Such commissions so allocated and the portions of all commissions paid on portfolio transactions allocated to non-executing brokers were property of the Fund, and were unlawfully diverted by the Adviser, to the damage of the Fund.

17. Such allocations of brokerage commissions to brokers or dealers supplying services to the Adviser or selling

Fund shares, but who did not actually execute the portfolio transactions, were designed to and did benefit the Adviser and the other defendants.

18. The prime purposes in making such allocations to said brokers or dealers has been to provide additional compensation for the sale of Fund shares (in addition to the regular sales commissions) and for the rendition of other services to the Adviser.

19. Said allocations deprive the Fund of its right to have portfolio transactions executed by brokers and dealers selected solely for efficiency in execution. It would have been possible for the Fund to arrange for lower brokerage costs by executing portfolio transactions in the so-called "Third Market", and by other execution methods at lower cost to the Fund. Such Third Market consists of dealers who make markets in securities for institutional investors, without minimum commission restrictions. Instead, the Fund is caused to pay the largest brokerage commissions to permit the Adviser to benefit by allocating said commissions as aforesaid. Such allocations confer no financial benefit on the Fund, but cause damage to the Fund.

20. The aforesaid methods of portfolio transaction executions enabled the Adviser to require brokers and dealers engaged in executing such transactions to give up a portion of their commissions to firms designated by the Adviser and

still retain sufficient portions thereof to profit therefrom.

21. The power to allocate commissions is an asset of the Fund. Defendants are under a fiduciary duty to exercise such power and execute portfolio transactions solely in the Fund's interest, without benefit to themselves, by effecting portfolio transactions at the lowest cost to the Fund.

22. By so misusing such power, defendants enable the Adviser and those receiving said allocations to derive benefits and deprire the Fund of benefits of reduced commissions because:

(a) such allocations relieved the Adviser of the need to itself pay additional compensation to its selling brokers and dealers.

(b) Such allocations provided extra stimulation for sale of Fund shares and increased the fees and commissions to the Adviser without benefit to the Fund.

(c) The Adviser was relieved of expenses for research, statistical and investment materials and services, quotations, advisory and economic data which it was obligated to furnish to the Fund, and for which it was compensated by the Fund.

23. James J. Minot, while a director, received $3,000 per annum from the Fund from 1966 through 1968. As a partner of the brokerage firm of Paine, Webber, Jackson &

Curtis, he also had an interest in amounts received by such firm during the years 1966 through 1968, respectively, of $124,272, $53,111 and $39,142 as reallowances on sales of Fund shares and $84,588, $73,114 and $14,912 as net brokerage commissions paid by the Fund.

24. Defendants caused or permitted the actions herein complained of by use of mails and of means and instrumentalities of interstate commerce, with knowledge or notice of the facts and illegality of practice, and pursuant to a plan to benefit themselves and thus damage the Fund. Said actions were committed in bad faith, were gross abuse of trust, gross negligence and disregard of fiduciary ditues, gross misconduct and willful misfeasance.

25. Demand upon the Fund to bring this action would be futile because those in control of the Fund are the wrongdoers and will not sue themselves. Control of such action by the directors would thus be control by the wrongdoers, thus preventing diligent prosecution.

26. Demand upon the shareholders of the Fund to bring this action is unnecessary and would be futile because:

(a) the wrongs constituted violations of the Acts and could not be ratified by the shareholders.

(b) The wrongs constituted gross abuse of trust and conversion under the Acts and could only be ratified by unanimous action.

(c) Management of Fund affairs, including institution of actions, is in the directors alone.

(d) A shareholder resolution to bring such action would be futile, since it would place control of such action in the hands of the wrongdoers.

(e) Demand would place unconscionable burden on the plaintiff in soliciting proxies from Fund shareholders.

(f) Demand would cause undue delay, be prejudicial and create danger of barring claims through operation of the statute of limitations or laches.

(g) Shareholders are too numerous to make it practicable to bring them all before this Court.

27. Plaintiff has no adequate remedy at law.

SECOND CAUSE OF ACTION

28. Plaintiff realleges paragraphs "1" through "27".

29. As the Fund grew from net assets at year-end 1958 of some $196,000,000 to about $532,000,000 at year-end 1970, brokerage commissions substantially increased. The Adviser recognized that brokerage commissions are payment for investment information as well as execution of portfolio transactions, and the Fund prospectus stated that brokerage commissions are directed to brokers in return for such investment information as well as execution of portfolio transactions, and brokerage commissions are directed to brokers in return for sale of Fund shares.

COMPLAINT

30. The Fund's net assets increased substantially through the years, due in large part to sale of Fund shares. Thus, at year-end 1958 when net assets were approximately $196,000,000, net assets per share were $9.93 and at December 31, 1970, when net assets were approximately $532,000,000, net assets per share were only $17.13. Since 1970, under the new management agreement which compares performance against the Standard & Poors Industrial Indices and in part bases the Adviser's fees upon such comparison, the fees paid the Adviser will increase and become more unreasonable, since they are based upon unfair criteria.

31. The new management agreement, in effect since 1970, was prepared and presented to stockholders for their approval without determining whether such management services could be secured elsewhere on terms more advantageous to the Fund, or whether the Adviser could continue to perform said services for less, all of which was not disclosed to the stockholders.

32. The benefits received by the Adviser from the allocations described, when added to fees received by the Adviser, insures that the total compensation paid by the Fund would be and has been unfair and unreasonable.

33. The same facilities and services used by the Adviser to supply services to the Fund are used by certain defendants to render services to clients and to another mutual

fund controlled by them, and they charge additional fees and expenses and utilize practices of allocations in connection with such other fund, without diminution of fees from the Fund. The benefits to defendants from such interrelated activities further render excessive the fees and charges derived from the Fund by Adviser.

34. The Adviser's duties with the Fund remained substantially constant over the years, although its fees increased substantially. Expenses to the Adviser, in dollars, of supervising the Fund have also remained substantially constant despite the increasing size of the Fund. But because of the method of computing the Adviser's fees, the expense ratio of the Fund has not declined substantially, although net assets have multiplied.

35. The Agreements between the Fund and the Adviser were collusively established and did not result from arm's length bargaining, since affiliated persons control and dominate the Fund.

36. The Fund and another mutual fund are mutually controlled by certain defendants and under mutual investment management and common distribution of defendants. As a result, defendants comingle the allocation of commissions from portfolio transactions of both funds, to their own benefit and to the damage of the Fund. Thus the assets of the Fund are

utilized for the benefit of defendants in their common control of both funds and for their other clients, in violation of requirements of the Investment Company Act of 1940 which requires segregation of each fund's assets.

WHEREFORE, plaintiff demands judgment

(a) requiring defendants, other than the Fund, jointly and severally to account to the Fund for its damages and for the profits and other benefits derived by defendants, or any of them, directly or indirectly, as a result of the acts and transactions herein alleged;

(b) requiring defendants to repay the Fund all moneys received by them from the Fund during the period of violations;

(c) restraining and enjoining defendants, their employees and agents, from continuing to commit the acts herein alleged;

(d) determining that defendants' brokerage methods and practices herein alleged are violations of the Acts;

(e) awarding plaintiff the costs and disbursements of this action, attorneys' fees and accountants' fees and expenses.

(f) granting such other relief as may be just.

Abraham J. Brill
Attorney for Plaintiff
10 East 40 Street
New York, New York 10016
Tel. (212) 683-0107

A-14

COMPLAINT

STATE OF NEW YORK)
: SS.:
COUNTY OF NEW YORK)

SUSAN TANNENBAUM, being duly sworn, deposes and says that she is the plaintiff in the within action; that she has read the foregoing complaint and knows the contents thereof; that the same is true to her own knowledge except as to the matters therein stated to be alleged on information and belief, and that as to those matters she believes it to be true.

/s/ Susan Tannenbaum

Sworn to before me this

30 day of April, 1971.

/s/ Joseph J. Berman
Notary Public, State of N.Y.
#24-5290750
Qualified in Kings Cty.
Commission Expires March 30, 1972

ANSWER OF DEFENDANTS F. EBERSTADT & CO., INC., *et al.*

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

SUSAN TANNENBAUM,	:	
Plaintiff,	:	71 Civ. 2104
-against-	:	ANSWER
ROBERT G. ZELLER, et al.,	:	
Defendants.	:	

Defendants F. Eberstadt & Co., Inc., F. Eberstadt & Co. Managers and Distributors, Inc. and Robert G. Zeller, by their attorneys Sullivan & Cromwell, answering the complaint herein:

FIRST CAUSE OF ACTION

1. Deny knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 1 of the complaint, except admit that records maintained by Chemical Fund, Inc. (the "Fund") disclose that a person named Susan Tannenbaum is an owner of record of shares of the Fund.

2. Deny each and every allegation contained in paragraph 2 of the complaint, except admit that they have not been in collusion with any party to confer on this Court jurisdiction it would not otherwise have.

3. Deny each and every allegation contained in paragraphs 3, 12, 14, 15, 16, 17, 22, 24, 25, 26 and 27 of the complaint.

4. Deny each
paragraph 4 of the compl
a Delaware corporation o
capital stock is 35 mill
ing as of December 31, 1
imately 67,000 sharehold
$532,361,416 as of Decem
increased during the per
May 11, 1971; and that f
of the United States mai
interstate commerce for

5. Deny each
paragraph 6 of the compl
& Co. Managers and Distr
corporation with offices
and distributor for the
owned by F. Eberstadt &

6. Deny knowl
form a belief as to the
paragraph 7 of the compl
of the phrase 'at all ma
that the persons listed
at certain times served

7. Deny each
paragraph 9 of the compl
distributor of the Fund'
public through non-affil
price that includes a co
allowed to non-affiliate

OF DEFENDANTS

and every allegation contained in
aint, except admit that the Fund is
rganized in 1938, that its authorized
ion shares, that there were outstand-
970 31,067,056 shares owned by approx-
ers; that it had net assets of
ber 31, 1970; that the Fund's assets
iod between December 31, 1970 and
rom time to time the Fund makes use
ls and other instrumentalities of
certain purposes.

and every allegation contained in
aint, except admit that F. Eberstadt
ibutors, Inc. ("M&D") is a Delaware
in New York City and acts as adviser
Fund and that its stock is wholly
Co., Inc.

edge or information sufficient to
truth of the allegations contained in
aint in the absence of a definition
terial times herein," except admit
in paragraph 7 of the complaint have
as directors of the Fund.

and every allegation contained in
aint, except admit that M&D acts as
s shares, which are offered to the
iated dealers at a public offering
mmission, a portion of which is re-
d dealers, which decreases with the

size of an order in accordance with a formula set fort in the Fund's prospectus. For the years ended 1966, 1967, 1968, 1969 and 1970, gross sales commissions paid to M&D were approximately $2,126,000, $1,599,000, $1,411,000, $1,328,000 and $2,099,000, respectively, from which the following amounts were reallowed to non-affiliated dealers: 1966--$1,677,000,; 1967--$1,237,000; 1968--$1,118,000; 1969--$1,034,000; 1970--$1,620,000.

8. Deny each and every allegation contained in paragraph 10 of the complaint, except admit that M&D also acts as adviser to The Eberstadt Fund, Inc.

9. Deny each and every allegation contained in paragraph 11 of the complaint, except admit that the Fund pays brokerage commissions on portfolio transactions executed on national securities exchanges.

10. Admit the allegations contained in paragraph 13 of the complaint, except aver that brokerage commissions paid by the Fund in 1969 in connection with Fund portfolio transactions were $472,757.

11. Deny each and every allegation contained in paragraph 18 of the complaint, except admit that it is the policy of the Fund that no brokerage business will be placed with any broker-dealer if, in the opinion of the Fund, the most favorable price and execution would not be obtained. Broker-dealers may receive orders to buy and sell securities for the Fund's portfolio and receive the resulting brokerage commissions. There is no undertaking or agreement to allocate

such business to broker-dealers on any prescribed basis. However, the extent to which such broker-dealers have sold shares of the Fund or have provided statistical and research information to the investment adviser are important factors in such allocation..

12. Deny each and every allegation contained in paragraph 19 of the complaint and aver that all transactions by the Fund are executed on a most favorable price and execution basis.

13. Deny each and every allegation contained in paragraph 20 of the complaint, except admit that prior to December 5, 1968, certain brokers were willing to give up a portion of their commissions to designated firms.

14. Deny each and every allegation contained in paragraph 21 of the complaint, except to the extent that such paragraph asserts conclusions of law which these defendants are not called upon to admit or deny.

15. Deny each and every allegation contained in paragraph 23 of the complaint, except admit that James J. Minot, as a director of the Fund, received directors' fees of $3,000 per annum from the Fund prior to his retirement from the Board on March 20, 1970 and aver on information and belief that as a limited partner of the stock exchange firm of Paine, Webber, Jackson & Curtis he also had an interest in amounts received by that firm as dealer sales commissions and as brokerage commissions and that the amounts received by such firm during the years 1966 through 1968 were as follows:

ANSWER OF DEFENDANTS

Year	Dealer Sales Commissions	Brokerage Commissions after Reallowance to Others
1966	$124,272	$84,588
1967	$ 53,111	$73,114
1968	$ 39,142	$14,912

SECOND CAUSE OF ACTION

16. In answer to paragraph 28 of the complaint repeat and reallege their answers to paragraphs 1 through 27 of the complaint as if set forth in full herein.

17. Deny each and every allegation contained in paragraph 29 of the complaint, except refer to the Fund's prospectuses for the statements contained therein.

18. Deny each and every allegation contained in paragraph 30 of the complaint, except admit that, as of December 31, 1958, the Fund's net assets were $196,376,283 and the net asset value per share (adjusted for stock split) was $9.93 and that, as of December 31, 1970, the Fund's net assets were $532,361,416 and the net asset value per share was $17.13 and after adjustment for reinvestment of capital gains distributions was $25.75.

19. Deny each and every allegation contained in paragraphs 31, 32, 33, 34, 35 and 36 of the complaint.

FIRST AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The claims asserted in the complaint are barred in whole or in part by applicable statutes of limitations.

SECOND AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The claims asserted in the complaint are barred in whole or in part by laches.

ANSWER OF DEFENDANTS

THIRD AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

Plaintiff failed to make the demand required by law upon the directors and stockholders of the Fund and such failure is not excused by the allegations contained in paragraphs 25 and 26 of the complaint.

FOURTH AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The claims asserted in the complaint are barred in whole or in part by the judgment of the Delaware Court of Chancery in an action entitled Heimelman v. Eberstadt.

FIFTH AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The management fees paid by the Fund and the brokerage practices of the Fund have been fully and fairly disclosed to the shareholders of the Fund and accepted and ratified by them, and plaintiff is therefore estopped to assert the claims alleged in the complaint.

WHEREFORE, these defendants demand judgment dismissing the complaint and awarding them the costs and disbursements of this action.

Dated: New York, New York
September 23, 1971

SULLIVAN & CROMWELL

By MARVIN SCHWARTZ
(A Member of the Firm)
Attorneys for Defendants
F. Eberstadt & Co., Inc.,
F. Eberstadt & Co. Managers
and Distributors, Inc. and
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48 Wall Street,
New York, New York 10005.
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ANSWER OF DEFENDANT CHEMICAL FUND, INC.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

- x

SUSAN TANNENBAUM, :

Plaintiff, : 71 Civ. 2104

- against - : ANSWER

ROBERT G. ZELLER, et al., :

Defendants. :

- x

Defendant Chemical Fund, Inc. (the "Fund"), by its attorneys, Walsh & Frisch, answering the complaint herein:

FOR ITS ANSWER TO
FIRST CAUSE OF ACTION

1. Denies knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 1 of the complaint, except admits that Susan Tannenbaum is an owner of record of shares of the Fund.

2. Denies each and every allegation contained in paragraph 2 of the complaint, except admits that it has not been in collusion with any party to confer on this Court jurisdiction it would not otherwise have.

3. Denies each and every allegation contained in paragraphs 3, 12, 14, 15, 16, 17, 22, 24, 25, 26 and 27 of the complaint.

4. Denies each and every allegation contained in paragraph 4 of the complaint, except admits that the Fund is a

ANSWER OF DEFENDANT CHEMICAL FUND, INC.

Delaware corporation organized in 1938, that its authorized capital stock is 35 million shares, that there were outstanding as of December 31, 1970 31,067,056 shares owned by approximately 67,000 shareholders; that it had net assets of $532,361,416 as of December 31, 1970; that the Fund's assets increased during the period between December 31, 1970 and May 11, 1971; and that from time to time the Fund makes use of the United States mails and other instrumentalities of interstate commerce for certain purposes.

5. Denies each and every allegation contained in paragraph 6 of the complaint, except admits that F. Eberstadt & Co. Managers and Distributors, Inc. ("M&D") is a Delaware corporation with offices in New York City and acts as adviser and distributor for the Fund and that its stock is wholly owned by F. Eberstadt & Co., Inc.

6. Denies knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraph 7 of the complaint in the absence of a definition of the phrase "at all material times herein," except admits that the persons listed in paragraph 7 of the complaint have at certain times served as directors of the Fund.

7. Denies each and every allegation contained in paragraph 9 of the complaint, except admits that M&D acts as distributor of the Fund's shares, which are offered to the public through non-affiliated dealers at a public offering

price that includes a commission, a portion of which is re-allowed to non-affiliated dealers, which decreases with the size of an order in accordance with a formula set forth in the Fund's prospectus. For the years ended 1966, 1967, 1968, 1969 and 1970, gross sales commissions paid to M&D were approximately $2,126,000, $1,599,000, $1,441,000, $1,328,000 and $2,099,000, respectively, from which the following amounts were reallowed to non-affiliated dealers: 1966--$1,677,000; 1967--$1,237,000; 1968--$1,118,000; 1969--$1,034,000; 1970--$1,620,000.

8. Denies each and every allegation contained in paragraph 10 of the complaint, except admits that M&D also acts as adviser to The Eberstadt Fund, Inc.

9. Denies each and every allegation contained in paragraph 11 of the complaint, except admits that the Fund pays brokerage commissions on portfolio transactions executed on national securities exchanges.

10. Admits the allegations contained in paragraph 13 of the complaint, except avers that brokerage commissions paid by the Fund in 1969 in connection with Fund portfolio transactions were $472,757.

11. Denies each and every allegation contained in paragraph 18 of the complaint, except admits that it is the policy of the Fund that no brokerage business will be placed with any broker-dealer if, in the opinion of the Fund, the most favorable price and execution would not be obtained.

Broker-dealers may receive orders to buy and sell securities for the Fund's portfolio and receive the resulting brokerage commissions. There is no undertaking or agreement to allocate such business to broker-dealers on any prescribed basis. However, the extent to which such broker-dealers have sold shares of the Fund or have provided statistical and research information to the investment adviser are important factors in such allocation.

12. Denies each and every allegation contained in paragraph 19 of the complaint, and avers that all transactions by the Fund are executed on a most favorable price and execution basis.

13. Denies each and every allegation contained in paragraph 20 of the complaint, except admits that prior to December 5, 1968, certain brokers were willing to give up a portion of their commissions to designated firms.

14. Denies each and every allegation contained in paragraph 21 of the complaint, except to the extent that such paragraph asserts conclusions of law which this defendant is not called upon to admit or deny.

15. Denies each and every allegation contained in paragraph 23 of the complaint, except admits that James J. Minot, as a director of the Fund, received directors' fees of $3,000 per annum from the Fund prior to his retirement from the Board on March 20, 1970, and avers on information and belief that as a limited partner of the stock exchange firm of Paine, Webber,

Jackson & Curtis he also had an interest in amounts received by that firm as dealer sales commissions and as brokerage commissions and that the amounts received by such firm during the years 1966 through 1968 were as follows:

Year	Dealer Sales Commissions	Brokerage Commissions after Reallowance to Others
1966	$124,272	$84,588
1967	$ 53,111	$73,114
1968	$ 39,142	$14,912

FOR ITS ANSWER TO
SECOND CAUSE OF ACTION

16. In answer to paragraph 28 of the complaint, repeats and realleges its answers to paragraphs 1 through 27 of the complaint as if set forth in full herein.

17. Denies each and every allegation contained in paragraph 29 of the complaint, except refers to the Fund's prospectuses for the statements contained therein.

18. Denies each and every allegation contained in paragraph 30 of the complaint, except admits that, as of December 31, 1958, the Fund's net assets were $196,376,283 and the net asset value per share (adjusted for stock split) was $9.93 and that, as of December 31, 1970, the Fund's net assets were $532,361,416 and the net asset value per share was $17.13 and after adjustment for reinvestment of capital gains distributions was $25.75.

19. Denies each and every allegation contained in paragraphs 31, 32, 33, 34, 35 and 36 of the complaint.

ANSWER OF DEFENDANT CHEMICAL FUND, INC.

FIRST AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The claims asserted in the complaint are barred in whole or in part by applicable statutes of limitations.

SECOND AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

Plaintiff failed to make the demand required by law upon the directors and stockholders of the Fund and such failure is not excused by the allegations contained in paragraphs 25 and 26 of the complaint.

THIRD AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The claims asserted in the complaint are barred in whole or in part by the judgment of the Delaware Court of Chancery in an action entitled Meiselman v. Eberstadt.

FOURTH AFFIRMATIVE DEFENSE
TO BOTH CAUSES OF ACTION

The management fees paid by the Fund and the brokerage practices of the Fund have been fully and fairly disclosed to the shareholders of the Fund and accepted and ratified by them.

WHEREFORE, the Fund demands judgment dismissing the complaint and awarding it the costs and disbursements of this action.

Dated: New York, New York
October 6, 1971

WALSH & FRISCH

by E. Roger Frisch
(A Member of the Firm)
Attorneys for Defendant
Chemical Fund, Inc.
250 Park Avenue
New York, New York 10017
(212) MU 7-7161

PRE-TRIAL ORDER.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

- x

SUSAN TANNENBAUM, :

Plaintiff, : 71 Civ. 2104 (RLC)

-against- : PRE-TRIAL ORDER

ROBERT G. ZELLER, et al., :

Defendants. :

- x

The attorneys for the parties having met at the direction of the Court pursuant to Rule 16 of the Federal Rules of Civil Procedure, the following action was taken:

1. The pleadings were deemed amended in accordance with the framing of the issues in this action in sub-paragraphs 3(b) and 3(c) of this Pre-Trial Order.

2. The parties agreed that the trial of this action shall be based upon this Order and upon the pleadings as amended thereby.

3. (a) The parties stipulate that the following facts are not in dispute in this action (each party reserving the right to object to the materiality of any such stipulated fact and its relevance to the issues).

(i) Since prior to 1/1/65 plaintiff has been and still is the record owner of shares of Chemical Fund, Inc. ("Fund").

(ii) Plaintiff brings this action derivatively on behalf, in the right and for the benefit of the Fund.

(iii) The matter in controversy, exclusive of interest and costs, exceeds the sum of $10,000.00

(iv) Plaintiff and defendant Robert G. Zeller are citizens of the State of New York. F. Eberstadt & Co., Inc. and F. Eberstadt & Co., Managers & Distributors, Inc. have their principal places of business in New York, New York.

(v) The Fund is a Delaware corporation, organized in 1938; its authorized capital stock is 150,000,000 shares, of which 92,631,460 shares were outstanding as of 12/31/73, owned by more than 100,000 shareholders.

(vi) The Fund had net assets of $433,849,751 on 12/31/65 and $897,333,945 on 12/31/73.

(vii) Since prior to 1/1/65 and from time to time to date, the Fund makes use of the United States mails and other instrumentalities of interstate commerce in the course of its business.

(viii) The Fund, since prior to 1/1/65 has been registered under the Investment Company Act of 1940 as an open-end diversified investment company, known as a mutual fund. Its objective is to attain growth of capital and income by investing in companies whose business is in certain aspects of the sciences. The Fund's offices are at 61 Broadway, in the Southern District of New York.

(ix) The Fund's manager and the distributor of its shares, pursuant to written contracts, has been since prior to 1/1/65 F. Eberstadt & Co., Managers & Distributors, Inc. ("M&D"), a Delaware corporation. Since 1/1/65 and prior thereto M&D has performed for the Fund

various management, statistical, accounting services, provides to the Fund advice and recommendations with respect to investment decisions and, subject to the Fund's Board of Directors, manages and supervises the business and affairs of the Fund. M&D also provides to the Fund office space and ordinary clerical and bookkeeping services. At all times since prior to 1/1/65 M&D has been a member of the National Association of Securities Dealers, Inc. ("NASD").

(x) F. Eberstadt & Co., Inc. ("Eberstadt"), a Delaware corporation, until 11/1/69 a partnership known as F. Eberstadt & Co., has owned all of the capital stock of M&D since 1/1/65 and at all times prior thereto. Eberstadt is and has been since 1962 a member firm of the New York Stock Exchange and a member of the NASD and in 1968 became an Associate Member of the American Stock Exchange and subsequently a member. By direction of the Fund's Board of Directors, Eberstadt has never acted as a broker or dealer in the execution of portfolio transactions for the Fund. Each year M&D has recommended that Eberstadt not act as a broker or dealer in the execution of portfolio transactions for the Fund.

(xi) At all times since prior to 1/1/65 a majority of the Fund's Board of Directors have been neither "affiliated" nor "interested persons" within the meaning of §§ 2a(3) 2a(19), 10(a) and 10(b) of the Investment Company Act. Since 1/1/65 the directors of the Fund have consisted of Messrs. F. Eberstadt (now deceased), Williams, Porter, Coles, Dorsett, Avery (until 1968), Driscoll, A. W. Eberstadt (until 1973), Hobbs, Marek (until 1970), Murray, Richard (until 1974), Rusk, Fox, Schneider and Zeller.

(xii) From prior to 1/1/65 until 4/1/70, the Fund paid M&D a quarterly management fee based upon the average daily net assets of the Fund.

PRE-TRIAL ORDER

(xiii) The management fees for the years 1965 through 1969 were:

YEAR	AMOUNT
1965	$1,160,563
1966	1,268,590
1967	1,428,228
1968	1,505,231
1969	1,521,868

(xiv) On 3/20/70 the Fund's shareholders approved a new management agreement which included a revised schedule of fees to M&D based in part upon the investment performance of the Fund.

(xv) On 5/14/71 the shareholders approved a revision of the schedule of fees to be paid to M&D.

(xvi) The management fee in each of the years 1970 through 1973 were:

YEAR	AMOUNT
1970	$1,662,203
1971	2,247,468
1972	3,097,640
1973	3,631,470

(xvii) M&D has since prior to 1/1/65 been the Fund's "principal underwriter" within the meaning of Section 2(a)(29) of the Investment Company Act. Pursuant to contract with the Fund, M&D has arranged for the sale of Fund shares to the public through unaffiliated securities dealers at a price equal to net asset value plus a sales charge. M&D under the terms of the contract, retains less than 25% of the sales charge and allows the balance as concessions to dealers.

(xviii) Since prior to 1/1/65, the Fund's Certificate of Incorporation, Article Eighth, Section B. 5(b) has provided as follows: "[T]he Board of Directors shall have power . . . to authorize the issue of sales of shares . . . from time to time . . . for a consideration, per share, to the [Fund] not less than the asset value, per share, of the outstanding shares of the [Fund]."

Also since prior to 1/1/65, the Fund's Certificate of Incorporation, Article Eighth, Section B.3 has provided that the Board of Directors has the power to "determine, in accordance with accepted accounting principle, what constitutes . . . net assets . . . ."

In addition, the Fund shareholders approved on March 14, 1972 an amendment to the Fund's Certificate of Incorporation with respect to the powers of the Board of Directors as they related to portfolio brokerage. This amendment added to the Certificate of Incorporation the underscored language below:

> "B. The Board of Directors shall have the entire management and control of the property, business and affairs of the Corporation, and is hereby vested with all the powers possessed by the Corporation itself so far as this delegation of authority is not inconsistent with law or this Certificate of Incorporation. In furtherance and without limitation of the foregoing provisions, it is expressly declared that, subject to this Certificate of Incorporation, the Board of Directors shall have power:
>
> .....
>
> "8. To determine in their discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund and the selection of the brokers and dealers that shall receive or share directly or indirectly in any such commissions and the basis of such receiving or sharing therein, including, but not limited to, sales of shares of the Fund and any other funds having the same investment adviser and statistical and other information and wire and other services provided to the Fund or the Manager."

PRE-TRIAL ORDER

The Proxy Statement distributed to Fund shareholders in connection with the meeting held on March 14, 1972 stated as follows with respect to the proposed amendment to the Certificate of Incorporation:

> "The purpose of the above amendment is to make explicit that which has always been implicit, namely, that the Board of Directors of the Fund (more than 50% of whom are otherwise unaffiliated with the Fund or its Manager) has the power to determine how the portfolio brokerage of the Fund shall be used. In the opinion of the Board of Directors of the Fund, it is in the best interest of the Fund to continue the brokerage practices which it has followed since inception under which all portfolio transactions have been carried out by brokers who are not affiliated with the Manager and Distributor of the Fund and not to make any provision for recapture through an affiliated broker of any part of the brokerage commissions paid by the Fund.
>
> "Accordingly, as reflected in the proposed new Management Agreement discussed below, the Board of Directors has directed the Manager not to have the Fund purchase or sell any portfolio securities through the firm of Eberstadt & Co., Inc., the parent of the Manager, which is a member of the New York and American Stock Exchanges. As indicated under "Allocation of Portfolio Brokerage and Portfolio Turnover Rate below in this proxy statement, the Fund's Board of Directors and the Manager consider that, subject to obtaining the best price, execution and commission, allocation of brokerage to dealers who have sold shares of the Fund or have provided statistical and research information has been and presently continues to be of benefit to the Fund and its shareholders. The Fund's Manager has been authorized by the Board of Directors to select in the Manager's discretion the brokers or dealers that shall execute portfolio transactions or share directly or indirectly in commissions with respect thereto, and to determine the basis of such sharing, subject in each case to obtaining the best execution taking into consideration, among other things, price (including any brokerage commission), size of the transaction and need for speed in execution. The Board, of course, would have the right to determine in the future that some other course of action might be desirable."

(xix) For the years 1965 through 1973, M&D received and allowed to dealers the amounts of charges indicated below:

YEAR	SALES CHARGE RECEIVED BY M&D	AMT. ALLOWED TO DEALERS	NET AMT. RETAINED BY M&D
1965	$ 1,678,130	$1,443,784	$ 234,346
1966	2,126,476	1,676,727	449,749
1967	1,599,478	1,236,823	362,655
1968	1,440,831	1,118,046	322,785
1969	1,328,119	1,034,212	293,907
1970	2,098,752	1,619,762	478,990
1971	3,166,064	2,433,832	732,232
1972	6,334,902	4,885,042	1,479,860
1973	10,751,197	8,251,184	2,500,013

(xx) Whenever the Fund seeks to purchase or sell securities for its portfolio it is necessary, except in unusual circumstances, to select a broker to execute the transaction or to deal directly with a dealer who owns or wishes to purchase the particular securities being purchased or sold. Since prior to 1/1/65, Fund portfolio transactions have been executed on the New York Stock Exchange, American Stock Exchange and regional stock exchanges. Of all transactions executed on such exchanges, approximately 80 percent have been executed on the New York Stock Exchange.

PRE-TRIAL ORDER

(xxi) For the years 1965 through 1973, brokerage commissions on the purchase and sale of the Fund's portfolio securities were:

YEAR	AMOUNT
1965	$ 339,860
1966	447,653
1967	617,787
1968	501,604
1969	472,757
1970	651,596
1971	920,767
1972	939,660
1973	1,291,735

(xxii) In selecting brokers for the execution of Fund portfolio transactions, M&D's primary concern is and has been at all times since prior to 1/1/65 the price and quality of execution to be provided to the Fund.

(xxiii) Since 1/1/65 and prior thereto, and until 7/15/73, and assuming equal price and quality of execution, the criteria used in selecting executing brokers were the broker's sales of Fund shares and the research and statistical services which he provided to M&D. Placing brokerage orders with a broker who had provided such other services is known as "reciprocal" brokerage. After 7/15/73 in accordance with a rule adopted by the NASD, a broker's sales of Fund shares was no longer a qualifying or disqualifying factor in the selection of executing brokers.

(xxiv) From prior to 1/1/65 until 12/5/68, it was a common practice for a mutual fund or its manager to direct executing brokers on the New York Stock Exchange ("NYSE"), American Stock Exchange and regional securities exchanges to "give-up" part of their commissions to other exchange members who had sold Fund shares or who had provided research or statistical material. During such period the commissions paid by funds for execution of portfolio

transactions on such exchanges did not exceed the minimum commissions prescribed by the respective constitutions and rules of such exchanges; the give-ups did not cause any increase thereof.

(xxv) Throughout the period of time that give-ups were permitted among members of the New York Stock Exchange, the American Stock Exchange and regional securities exchanges, such exchanges required their members to charge for the execution of transactions on such exchanges an amount no less than the minimum commission prescribed by the constitution and rules of such exchanges. During such period of time, each commission paid by the Fund with respect to the execution of a portfolio transaction on such exchanges, did not exceed the minimum commission prescribed by the constitution and rules of such exchanges.

(xxvi) Until "give-ups" were abolished by amendments to stock exchange rules on 12/5/68, the Fund followed the industry practice described herein of directing executing brokers on stock exchanges to "give-up" part of their commissions to other exchange brokers who had provided sales, statistical or research services and who had not participated in the execution of the transactions. Securities dealers who received give-ups for statistical or research services received no other compensation for such services.

(xxvii) In each of the years 1965 through 1968, M&D directed give-ups in excess of the amounts below indicated:

YEAR	AMOUNT
1965	$ 81,686
1966	136,200
1967	214,600
1968	246,600

PRE-TRIAL ORDER

(xxix) While the Constitution and rules of the New York Stock Exchange, American Stock Exchange and regional securities exchanges have always prohibited the rebate of commissions to customers, the NYSE, American Stock Exchange and certain regional exchanges have always permitted member firms who serve as investment advisers to credit against the investment advisory fee some portion of the commissions earned by the member firm for the execution of portfolio transactions for the investment advisory client.

(xxx) Since prior to 1/1/65 and until 12/5/68 the Constitution and rules of the NYSE permitted Eberstadt to receive give-ups from other member firms of the NYSE who executed portfolio transactions for the Fund and to credit give-ups so received against the management fee payable to M&D by the Fund. Since 1/1/65 to date the Constitution and rules of such exchanges would have permitted M&D to credit against the management fee payable to it by the Fund some portion of any brokerage commissions earned by Eberstadt in the execution of the Fund's portfolio transactions.

However, each year the Board of Directors of the Fund has directed that Eberstadt not act as broker or dealer in the execution of Fund portfolio transactions and that in the pre-12/5/68 period it not receive give-ups from other brokers in connection with Fund portfolio transactions. Each year M&D has recommended that Eberstadt not act as a broker or dealer in the execution of portfolio transactions and that, in the pre-12/5/68 period, it not receive give-ups from other brokers in connection with Fund portfolio transactions.

(xxxi) The crediting of give-ups and of some portion of brokerage commissions on portfolio transactions against the management fee (except for give-ups, which were abolished on 12/5/68) was permissible under the rules of the NYSE until the adoption of the present Article IX, Section 7(k) of the Constitution of the New York Stock Exchange on January 29, 1973 and of the present Rule 318 of the New York Stock Exchange on 2/1/73. Similar rules have been adopted by the American Stock Exchange and regional exchanges.

(xxxii) From 1/1/65 through 12/31/70, portfolio transactions and resultant commissions, were allocated by M&D to brokers, based on the volume of Fund shares sold, in the amounts below indicated (each dealer who sold Fund shares also received a portion of the sales charge as described in the prospectus):

YEAR	AMOUNT
1965	$271,910
1966	379,752
1967	510,346
1968	430,150
1969	363,036
1970	462,613

(xxxiii) As of 7/15/73, the NASD adopted a Rule mandating that the sale of Fund shares shall be neither a qualifying nor a disqualifying factor in the allocation of portfolio transactions.

(xxxiv) During the years listed below, portfolio transactions, and resultant commissions, allocated by M&D to brokers for research and statistical services rendered by them to M&D were:

YEAR	AMOUNT
1965	$ 40,977
1966	42,900
1967	61,600
1968	45,967
1969	46,454
1970	91,662

(xxxv) During 1971, 67% of portfolio brokerage in terms of commissions was done through broker-dealers who, in addition to supplying the best execution, both provided statistical and research information and sold Fund shares: an additional 20% was done through those who, in addition to supplying the best execution, sold Fund shares but did not provide any other service and an additional 11% was done through those who, in addition to supplying the best execution, provided statistical and research information only.

(xxxvi) During the fiscal year ended December 31, 1972, [illegible]% of portfolio brokerage in terms of commissions was done through broker-dealers who, in addition to supplying the best execution, both provided statistical and research information and sold Fund shares; an additional 6% was done through those who, in addition to supplying the best execution, sold Fund shares but did not provide any other service and an additional 13% was done through those who, in addition to supplying the best execution, provided statistical and research information only.

(b) Plaintiff contends:

(i) Where recapture of commissions on portfolio transactions is freely available to a mutual fund, its directors have no choice but to recapture such commissions for the benefit of the Fund.

(ii) When a mutual fund sells its shares at net asset value, but at the same time rewards the selling broker with commissions on portfolio transactions which the mutual fund itself has the right to and can recapture for its own benefit, the net amount received by the fund is less than net asset value.

(iii) Commissions on portfolio transactions available for recapture by a mutual fund may not be used by its manager and distributor to reward brokers for sales.

(iv) Commissions on portfolio transactions available for recapture by a mutual fund may not be used by its manager and distributor to reward brokers for research and statistical services.

(v) Making allowances for best execution, the defendants (other than the Fund) are liable to the Fund for all commissions on portfolio transactions which could have been recaptured.

(vi) By causing the Fund to forego recapture of those portions of the commissions on portfolio transactions which were freely available to the Fund, defendants (other than the Fund) violated their fiduciary duties to the Fund.

(vii) By causing the Fund to forego recapture of those portions of the commissions on portfolio transactions which were freely available to the Fund, defendants (other than the Fund) breached M&D's management and distribution contracts with the Fund.

(viii) By causing the Fund to forego recapture of those portions of the commissions on portfolio transactions which were freely available to the Fund, defendants (other than the Fund) violated the charter provision of the Fund which required the Fund to receive full asset value upon the sale of its shares.

(ix) The "give-ups", referred to in Finding of Fact ~~xxv~~ xxvii, should have been directed to F. Eberstadt & Co. and applied to reduce the advisory fee.

PRE-TRIAL ORDER

(x) The allocation of portfolio transactions, referred to in Findings of Fact xxxii, xxxiv and xxxvi, should have been directed to F. Eberstadt & Co. or F. Eberstadt & Co., Inc., and the profits arising therefrom applied to reduce the advisory fee.

(xi) The allocation of portfolio transactions, referred to in Findings of Fact xxxiv, xxxv and xxxvi, should have been directed to F. Eberstadt & Co. or F. Eberstadt & Co., Inc., and the profits arising therefrom applied to reduce the advisory fee.

(xii) Preferred rate non-membership on the Pacific, Boston and Detroit regional exchanges would have enabled F. Eberstadt & Co., or F. Eberstadt & Co., Inc., or M&D to recapture a portion of the commissions on portfolio transactions there executed, which portion should have been applied to reduce the advisory fee.

(c) Defendants contend:

(i) The decision made from time to time not to recapture portfolio brokerage commissions was a good-faith business decision made in the independent business judgment of the Fund's Board of Directors, a majority of whom were at all times unaffiliated with M&D or Eberstadt.

(ii) The decision not to recapture was not a decision made by M&D or Eberstadt, nor did M&D nor Eberstadt cause said decision to be made.

(iii) The decision whether or not to involve Eberstadt and M&D in the execution of Fund portfolio transactions, for recapture or any other purpose, was entirely a matter of the business judgment of the Fund's Board of Directors.

(iv) There is no legal requirement that a mutual fund recapture portfolio brokerage commissions regardless of all other considerations.

(v) There were proper and valid business objectives to be served by the directors' decision that Eberstadt and M&D were not to become involved directly or indirectly, in the execution of Fund portfolio transactions.

(vi) The Fund was not damaged by the decision of the Fund's Board of Directors that Eberstadt and M&D were not to become involved, directly or indirectly, in the execution of Fund portfolio transactions.

(vii) The Fund's certificate of incorporation does not require that portfolio brokerage commissions be recaptured when such recapture is available.

(viii) The availability of portfolio brokerage commissions which could be recaptured is not a component in the determination of the Fund's daily net assets.

(ix) The Fund received net asset value on all sales of its shares.

(x) Defendants have violated no contractual, statutory, or common-law duty to the Fund or its shareholders.

(xi) The amount of portfolio brokerage commissions which could have been recaptured, consistent with best execution, cannot be proved.

(xii) This action is barred by laches and estoppel.

(xiii) This action is barred in part by the applicable statute of limitations.

4. (a) The exhibits which each party now expects to offer at the trial are identified in subdivision (b) hereof. Should any party hereafter decide to offer additional exhibits, prompt notice of that fact shall be given to each other party in writing. No exhibit shall be offered at trial unless the above procedure has been complied with.

PRE-TRIAL ORDER

(4) The parties agree that the following documents which were marked for identification or which are otherwise identified in this Order are authentic and may be received in evidence (each party reserves the right to object to the materiality or relevancy of each document).

The following documents marked by plaintiff for identification at the depositions: 32, 61-116, 121, 125, 126, 128, 137, 138, 141, 142, 145-147, 149, 150, 152, 161, 168-176, 181-196, 199-201, 205-219, 229-230; Fund prospectus dated April 30, 1974; Fund Certificate of Incorporation as amended in 1972 and in 1973; minutes or excerpts thereof of each Board or shareholder meeting at which management agreement was approved; proxies of plaintiff as voted; ~~table of net sales of Fund and industry~~; reports on memoranda to directors dated 2/19/69, 1/22/70, 2/17/71, 3/27/72 and 1/15/73; ~~Review of Operations dated 1/10/69, 1/9/70, 1/15/71, 12/13/71~~; ~~resumes of unaffiliated directors or applicable portions of "Who's Who~~;" "Martin Report;" proposed amendment to NYSE Rule 340A.11; Article IX, Section 7(a) of NYSE Constitution· NYSE Rules 2, 312 and 318; transcripts of the depositions of Messrs. Zeller, Murray and Dorsett. In addition, either party may offer the rules or Constitution of any national securities exchange as they appear in any published source.

5. The parties agree that the witnesses whom each party now intends to call are those listed below; however, ~~the~~ no party is obligated to call such witnesses. Should any party hereafter decide to call any additional witnesses, prompt notice of the identity shall be given to each party in writing. Such notice shall set forth the reason why the witnesses were not theretofore identified.

PRE-TRIAL ORDER

Plaintiff's witnesses:

Robert G. Zeller;
Roger F. Murray;
Burt N. Dorsett;
Robert C. Porter;
Alfred E. Driscoll; and
John F. VanDeventer.

Defendants' witnesses:

Robert G. Zeller;
Francis S. Williams;
Roger F. Murray;
Robert C. Porter;
Dr. James S. Coles;
Burt N. Dorsett;
Alfred E. Driscoll;
Dr. Bertrand Fox;
Whitman Hobbs;
G. Lawton Johnson;
Bradford Mills;
Dr. Howard A. Rusk;
John F. VanDeventer; and
A partner from Price Waterhouse and Co. who will testify about the computation of net asset value.

6. Plaintiff agrees not to call any expert on the issue of liability, reserving the right to call an expert on damages. If such an expert is called, plaintiff will give defendants prompt notice of his identity and the subject matter of his testimony.

7. The following are all of the claims for relief asserted by plaintiff:

(a) Defendants other than the Fund should be required jointly and severally to account to the Fund for all damages sustained by the Fund and for all profits and other benefits derived by M&D, directly or indirectly, by reason of the failure to recapture those portions of the commissions on portfolio transactions which were freely available to the Fund.

(b) Defendants other than the Fund should be required jointly and severally to repay to the Fund all such damages sustained by the Fund and all such profits derived by M&D.

PRE-TRIAL ORDER

(c) Defendants should be restrained and enjoined from continuing to allocate brokerage commissions on the Fund's portfolio transactions as a reward to brokers and dealers who provide sales of Fund shares or statistical and research information to M&D.

(d) The Fund should be required to pay plaintiff the costs and disbursements of this action, including attorneys' and accountants' fees.

8. (a) The parties agree to waive a trial by jury and consent to trial of the issues in this action before Hon. Robert L. Carter, United States District Judge, without a jury.

(b) Plaintiff at this time expects to require 3 trial days on the issue of liability and, should the Court determine that liability exists, an additional 15 trial days to determine the damages to the Fund and the profits and other benefits derived by M&D.

Defendants at this time expect to require 5 trial days on all the issues in the case. The defendants contend that the issues of liability and damages are inextricably related and should be tried together.

Dated: New York, N.Y.

September , 1974

SO ORDERED

United States District Judge

CONSENTED TO:

By

Leonard I. Schreiber
Attorney for plaintiff
30 Park Avenue
New York, New York
(212) MU 9-1810

PRE-TRIAL ORDER

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STIPULATION CORRECTING TRIAL TRANSCRIPT.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

SUSAN TANNENBAUM,	:	
Plaintiff,	:	71 Civ. 2104 (RLC)
-against-	:	STIPULATION
ROBERT G. ZELLER, et al.,	:	
Defendants.	:	

IT IS HEREBY STIPULATED AND AGREED, by and among the undersigned attorneys for the parties that the trial transcript herein be corrected as follows:

CORRECTIONS TO TRIAL TRANSCRIPT

p. 2, line 9 - change "Tannerbaum" to "Tannenbaum";

p. 14, line 20 - change "only" to "also";

p. 17, line 19 - add "taxes" after "franchise";

p. 18, line 18 - delete "4";

p. 18, line 19 - delete "to 5" and replace with "425";

p. 19, line 6 - delete "of";

p. 19, line 11 - change "funds" to "fund's shares";

p. 24, line 10 - change "thin" to "think";

p. 29, line 10 - change "and" to "in";

p. 32, line 3 - change "thgt" to "that";

p. 34, line 22 - change "and" to "a";

p. 34, line 23 - add "some" after "gotten";

p. 34, line 25 - change "in" to "and";

p. 36, line 5 - change "Bob" to "John" and change "Derventer" to "Deventer";

STIPULATION CORRECTING TRIAL TRANSCRIPT

p. 37, line 20 - change "the" to "our";

p. 38, line 6 - after "No." there should be a paragraph "Q";

p. 43, line 12 - change "Boden" to "Bowdoin";

p. 43, line 20 - change "Dawson" to "Dorsett";

p. 44, line 24 - change "his" to "him";

p. 45, line 19 - add "chemical" after "largest";

p. 46, line 17 - change second "a" to "the";

p. 46, line 18 - add "Colt" after "Sloane" and "Graduate" after "the";

p. 46, line 18 - delete "Advanced";

p. 46, line 22 - change "Dawson" to "Dorsett";

p. 47, line 17 - change "Numont" to "Newmont";

p. 48, line 23 - change "aw" to "a";

p. 50, line 3 - change "commiissions" to "commissions";

p. 50, line 14 - change "fised" to "fixed";

p. 52, line 6 - change "fir" to "for";

p. 58, line 17 - change "Joretski" to "Jaretzki";

p. 58, line 19 - change "not" to "now";

p. 61, line 23 - change "broad" to "both";

p. 62, line 6 - change "had" to "has";

p. 62, line 8 - change "Derventer" to "Deventer";

p. 63, line 10 - change "in this case. We" to ". In this case we";

p. 66, line 17 - add "as" after "just";

p. 70, line 19 - change "No." to "Yes,";

p. 70, line 20 - change "Q But what they are." to ", they are.";

p. 70, line 21 - add "Q" before "What";

p. 70, line 24 - change "expensive" to "expense";

STIPULATION CORRECTING TRIAL TRANSCRIPT

p. 73, line 4 - change "negotiating" to "negotiated";

p. 73, line 7 - change "is" to "was";

p. 76, line 6 - change "as it is" to "at it";

p. 76, line 23 - change "ante" to "anti";

p. 76, line 23 - delete "have";

p. 78, line 3 - add "industry" after "company";

p. 78, line 5 - change "side" to "size";

p. 78, line 6 - change "has" to "had";

p. 80, line 22 - change "your" to "our";

p. 84, line 23 and 25 - change "Derventer" to "Deventer";

p. 102, line 2 - add "the same" after "gotten";

p. 104, line 24- change "we" to "I";

p. 105, line 6 - change "charge" to "charter";

p. 110, line 4 - change "and" to "in";

p. 119, line 15- add a comma after "that";

p. 119, line 16- add a comma after "consideration";

p. 129, line 2 - add "for" after "distributing";

p. 140, line 9 - change "yout" to "your";

p. 140, line 17- change "19∉6" to "1966";

p. 141, line 12- change "the" to "there";

p. 141, line 13- change "governs" to "govern";

p. 145, line 6 - change "asset net" to "net asset";

p. 145, line 15- change "1972" to "1973";

p. 147, line 7 - change "permits" to "provides";

p. 147, line 14- change "analyze" to "analyzed" and add "purchase" after "and";

p. 150, line 20- change "liability fee" to "fee liability".

STIPULATION CORRECTING TRIAL TRANSCRIPT

p. 157, line 18 - change "Sloane-Cole" to "Sloan Colt";

p. 159, line 18 - change "Survey" to "Surveyor";

p. 161, line 8 - delete ",sit,";

p. 163, line 24 - change "Fred" to "Ferd";

p. 167, line 19 - change "Implementation" to "Implications";

p. 171, line 18 - change "mere" to "me";

p. 172, line 19 - change "Derventer" to "Deventer";

p. 201, line 15 - change "Qnd" to "And";

p. 214, line 17 - change "Schiffman" to "Schiff";

p. 218, line 23 - add "and" after "function";

p. 229, line 3 - change first "I" to "it";

p. 230, line 8 - add "time" after "same";

p. 260, line 24 - change "Der Venter" to "Deventer";

p. 263, line 18 - add "--" after "member";

p. 264, line 24 - change "made" to "had";

p. 265, line 7 - add "been" after "have";

p. 265, line 9 - replace "there was ICO, the organization that handles mutual funds--" with "through the -- what is it -- oh, what is the organization that handles the mutual funds --";

p. 267, line 7 - add "who" after "sure"; and

p. 269, line 8 - change "fund shares" to "the Fund's shares".

Dated: New York, New York
March 25, 1975

By _____
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STIPULATION CORRECTING TRIAL TRANSCRIPT

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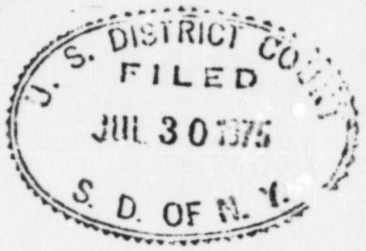
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SO ORDERED:

_____
United States District Judge

OPINION OF THE DISTRICT COURT (CARTER, J.).



UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- x

SUSAN TANNENBAUM,

Plaintiff,

- against -

71 Civ. 2104

ROBERT G. ZELLER, FRANCIS S. WILLIAMS, ROBERT C. PORTER, JAMES S. COLES, BURT N. DORSETT, JULIAN M. AVERY, ALFRED E. DRISCOLL, ANDREW W. EBERSTADT, WHITMAN HOBBS, LEROY F. MAREK, JAMES J. MINOT, ROGER F. MURRAY, AUGUSTE RICHARD, BERTRAND FOX, HOWARD A. RUSK, F. SCHNEIDER, ESTATE OF F. EBERSTADT, F. EBERSTADT & CO., INC., F. EBERSTADT & CO. MANAGERS AND DISTRIBUTORS, INC. and CHEMICAL FUND, INC.,

Defendants.

- x

42885

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Robert G. Zeller

CARTER, District Judge

OPINION OF THE DISTRICT COURT (CARTER, J.)

I.

This is a derivative action bought pursuant to Section 44 of the Investment Company Act of 1940, as amended (15 U.S.C. §80a-43); Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa); and Section 22 of the Securities Act of 1933 (15 U.S.C. §77v). Plaintiff, who has been a shareholder of record of the Chemical Fund (Fund) continuously since at least 1965, sues on behalf of the Fund.

The latter, a Delaware corporation, is an open end "mutual fund" registered with the Securities and Exchange Commission under the Investment Company Act. The Fund's principal activity is its varied investments in the chemical process industry. On December 31, 1965, the net total assets of the Fund were $433,849,751, and as of December 31, 1973, these assets had registered a more than 100% growth totaling $897,333,945. While the net total assets at the time of trial in 1974 were down to approximately 706 million dollars, a reflection of the general downward economic trend in this country, the Fund's performance still compared favorably with like investment operations.

The Fund's manager and distributor of shares, pursuant to written contracts, is F. Eberstadt & Co., Managers & Distributors, Inc. (M&D), also a Delaware corporation. M&D is a subsidiary of F. Eberstadt & Co., Inc., a brokerage house founded by the late F. Eberstadt, who also served on the board of the Fund. M&D provides staff, offices, advice and recommendations to the Fund and manages and supervises the business and affairs of the Fund, subject to the latter's Board of Directors, a majority of whom are disinterested or unaffiliated directors; that is, having no association with F. Eberstadt & Co. or M&D, within the meaning of Sections 2(a)(3), 2(a)(19), 10(a) and 10(b), of the Investment Company Act, 15 U.S.C. §§80a2(a)(3), 80a2(a)(19), 80a10(a), and 80a10(b). The management agreement and the distribution agreement obligate M&D to provide all statistical and research services at M&D's expense and to pay for the sale and distribution of Fund shares.

The unaffiliated or disinterested Fund directors are men of repute in academia, business and the professions. Among them are Dr. James S. Coles, director since 1968, currently President of Research Corporation, a foundation for the advancement of science, and before that President of Bowdoin College; Burt N. Dorsett, director since 1966, currently Vice President and Senior Investment Officer for College Retirement Equities Fund, and former Vice President for investments at the University of Rochester;

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Alfred E. Driscoll, director since 1957, currently Chairman of the New Jersey Turnpike Authority and former governor of New Jersey; Dr. Bertrand Fox, director since 1970, recently retired Professor of Investment Banking at Harvard University Graduate School of Business Administration; Dr. Roger F. Murray, director since 1959, Professor of Banking and Finance at the Columbia University Graduate School of Business, formerly Vice President, responsible for portfolio management at Bankers Trust Co., and at one time manager of the investment portfolio of the Teachers Insurance and Annuity Association & College Retirement Equities Fund; Whitman Hobbs, director since 1972, John N. Martin, Franz Schneider, long time director, and Julian Avery, director until 1968, holding responsible positions in various corporate business institutions; Dr. Howard Rusk, director since 1962, well-known authority on rehabilitation and other medical questions; Leroy Marek, director from 1959-1973, a consultant on scientific problems and issues; and James J. Minot, director from 1968-1970, senior partner in Paine, Webber, Jackson & Curtis, Inc.

The parent company, Eberstadt (formerly a partnership), until 1972 owned all the capital stock of M&D, and since that time has held 75% of M&D's stock.

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Eberstadt since 1962 has been a member of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) and continuously since 1970, a member or associate member of the American Stock Exchange (AMEX). Robert Zeller, the only individual defendant served, is Vice Chairman of the Fund's Board and of M&D's Board. Prior to the incorporation of Eberstadt, Zeller was a partner in the firm. Since its incorporation he has been chairman of its Board and its chief executive officer.

Prior to 1971, the constitution and rules of the New York Stock Exchange required all members to charge at least a prescribed minimum commission on all transactions without regard to size or profitability. Moreover, the Exchange had always and continues to prohibit any direct rebate to a customer of any part of a commission earned by a member in the execution of a transaction, i.e., the consummation of a trade, on the exchange. The costs of executing large orders, however, were not proportionately higher than the execution costs of small orders. But for the minimum commission regulation, broker-dealer firm members of NYSE in competing for business would have been willing to reduce their commissions based on quantity discounts to the

customer. The unavailability of this form of discount led to a widespread practice in the mutual fund industry of customer directed "give-ups." Thus prior to December 5, 1968, it was common practice, custom and usage for a mutual fund through its manager to direct executing brokers on the NYSE and other national securities exchanges to "give up" part of their commission to other exchange members who had no part in the execution of the transaction. [1] The "give-up" was normally directed to a non-executing broker but one who had sold the shares of the mutual fund to the public and/or who had provided useful research and statistical information.

For the years 1965 through 1973, the Fund paid gross commissions to M&D, a portion of which M&D paid to non-affiliated dealers, in the amounts indicated below:

YEAR	SALES CHARGE RECEIVED BY M&D	AMT. ALLOWED TO DEALERS	NET AMT. RETAINED BY M&D
1965	$ 1,678,130	$1,443,784	$ 234,346
1966	2,126,476	1,676,727	449,749
1967	1,599,478	1,236,823	362,655
1968	1,440,831	1,118,046	322,785
1969	1,328,119	1,034,212	293,907
1970	2,098,752	1,619,762	478,990
1971	3,166,064	2,433,832	732,232
1972	6,334,902	4,885,042	1,479,860
1973	10,751,197	8,251,184	2,500,013

[1] For a fuller explanation of "give-ups" and their raison d'etre, see Fogel v. Chestnutt, 383 F. Supp. 914, 915-919 (S.D.N.Y. 1974).

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Between 1965 and 1973, the Fund paid brokerage commissions for the execution of purchases and sales of securities on behalf of the Fund on the NYSE, on which 80% of the portfolio transactions were executed, the AMEX and regional securities exchanges in the following amounts:

YEAR	AMOUNT
1965	$ 339,860
1966	347,653
1967	617,787
1968	501,604
1969	472,757
1970	651,596
1971	920,767
1972	939,660
1973	1,291,735

From January 1, 1965 through December 5, 1968, brokers who executed transactions were directed by the Fund through M&D to "give up" a portion of their commissions to brokers and dealers who performed no services in the execution of these transactions. The "give-ups" were awarded to these non-executing brokers and dealers for services rendered in the selling of Fund shares and in providing statistical or research services without making any charge therefor. The "give-ups" constituted a substantial portion of the execution commission which, as previously suggested, executing brokers and dealers willingly shared because the low cost of execution was

more than adequately met by the minimum commissions specified. These "give-ups" from 1965 to 1968 exceeded the following amounts:

YEAR	AMOUNT
1965	$ 81,686
1966	136,200
1967	214,600
1968	246,600

From January 1, 1965, through July 15, 1973, one of the bases on which brokers and dealers were chosen as executing brokers or dealers to handle a portfolio transaction for the Fund was to reward them for the sale of Fund shares. During the years 1965 - 1970, commissions paid by the Fund when the sale of Fund's shares was a criterion for selection of an executing broker were as follows:

YEAR	AMOUNT
1965	$271,910
1966	379,752
1967	510,346
1968	430,150
1969	363,036
1970	462,613

During that period and to date another basis for the selection of executing brokers was to compensate them for providing statistical and research services to the Fund through M&D. The commissions paid in connection with such transactions were as follows:

YEAR	AMOUNT
1965	$40,977
1966	42,900
1967	61,000
1968	45,967
1969	46,454
1970	91,662

These allocations are known as reciprocal brokerage, and approximately 98% of the Fund's portfolio transactions were allocated on this basis. After July 15, 1973, pursuant to a rule adopted by the NASD, the sale of Fund shares could no longer be a criterion for selection or non-selection of an executing broker or dealer.

While direct customer rebates were prohibited by the NYSE and AMEX and certain regional securities exchanges, a member firm serving as an investment advisor was not prohibited from crediting against its investment advisory fee some portion of the commission it earned from execution of portfolio transactions for the investment advisory client. Thus, M&D would have

been permitted to credit against its management fee from the Fund some portion of any brokerage commission earned by Eberstadt in the execution of the Fund's portfolio transactions; and before "give-ups" were abolished, it would have been possible for Eberstadt to have received "give-ups" from other member firms who acted as executing brokers for the Fund and for such "give-ups" to be credited against the Fund's management fee.

That fee, while based on a percentage lower than most in the industry, was not insubstantial as the management fees between 1965 and 1969 listed below indicate:

YEAR	AMOUNT
1965	$1,160,563
1966	1,268,590
1967	1,428,223
1968	1,505,231
1969	1,521,868

On March 20, 1970, and on March 14, 1971, the formula for computation of the management fee was revised, and the fees in the years since have been as follows:

YEAR	AMOUNT
1970	$1,662,203
1971	2,217,468
1972	3,097,640
1973	3,361,470

"Give-ups" were abolished by a rule of the NYSE effective December 5, 1968. Recapture of commissions or a portion thereof, however, was permissible in other respects until adoption of Article IX, Section 7(k) of the Constitution of the NYSE on January 29, 1973, and of the present Rule 318 of the NYSE on February 1, 1973. Similar rules have now been adopted by the AMEX and various regional exchanges.

The plaintiff's basic contention is that from January 1, 1965, until December 5, 1968, when "give-ups" were prohibited by NYSE rules, and up to the present when recapture of excess commissions was available, defendants were required to use the Fund-directed "give-ups" and the recapture of excess commissions for the benefit of the Fund; that prior to December 14, 1970, the use of excess commissions to discharge MSD obligations under its management and distribution agreements with the Fund violated §§36 and 1(b).(2) of the Investment Company Act (15 U.S.C. §§80a-35 and 80a-1(b)(2)), entitling plaintiff to recover on behalf of the Fund; and that such use of

excess commissions after December 15, 1970, violated §§36(a) and 1(b)(2) of the Investment Company Act (15 U.S.C. §§80a-35(a) and 80a-1(b)(2)), entitling plaintiff to recover damages on behalf of the Fund; and that such use from January 1, 1965, to the present constituted a breach of fiduciary duty at common law entitling plaintiff to recover damages on behalf of the Fund.

OPINION OF THE DISTRICT COURT (CARTER, J.)

II

Plaintiff's chief reliance is on Moses v. Burgin, 445 F. 2d 369 (1st Cir.), cert. denied sub nom. Johnson v. Moses, 404 U.S. 994 (1971). Before proceeding further a few threshold observations may be helpful. Plaintiff may be correct in her view that the basic thrust of Burgin is that the management of a mutual fund is obligated to use all proper means to secure excess brokerage commissions for the benefit of the Fund. However, application of that principle to this case will not necessarily result a fortiori, as plaintiff seems to suggest, in a conclusion that failure of NASD to direct "give-ups" or to recapture excess commissions through itself or Oberstadt violates the Investment Company Act or constitutes a breach of any common law obligation.

The facts in Moses v. Burgin are quite different from the facts developed in this case. As here, customer directed "give-ups" were paid over at management's behest to brokers who sold Fund shares. The court held that there was a duty to recapture the excess commissions for the benefit of the Fund if freely available, and that the directors had no choice. The court found that the management company as a member of NASD could have joined various regional

exchanges as a special member and could have become qualified to receive "give-ups" on those exchanges. 445 F. 2d at 37 The court determined that the possibility of recapture through NASD or the regional exchanges was not disclosed to the unaffiliated directors, and that the management was under a duty to disclose all such information to the unaffiliated directors to permit them to decide what to do. Moreover, the court placed emphasis on a report of the Securities and Exchange Commission, Public Policy Implications of Investment Company Growth, H.R. Report, No. 2337, 89th Congress, 2d Sess. (1966) ("PPI"), issued one year before commencement of the litigation in Burgin in which it is stated, at p.173, that "give-ups" should be directed to advisor underwriters for the purpose of applying those "give-ups" to reduce the advisory fees payable by the Fund. Also the court cited with confidence proposed Rule 10b-10 pursuant to which the SEC would require all excess commissions to be applied to a reduction of the advisory fee.

There is no evidence of non-disclosure by M&D to the unaffiliated directors in this case, and the SEC has fully retreated from its proposed Rule 10b-10 and at least in part from its unqualified position in the PPI report that "give-ups" be directed to reduction of advisory fee

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The Burgin formulation has not been adopted in this circuit. It has, of course, been discussed, see Weiss v. Chalhec, 55 F.R.D. 168 (S.D.N.Y. 1972) and 59 F.R.D. 533 (S.D.N.Y. 1973); Fogel v. Chestnutt, 383 F. Supp. 914 (S.D.N.Y. 1974); Frankel v. Hyde, CCH Fed. Sec. L. Rep. ¶94,436 (S.D.N.Y. April 4, 1974); and White v. Auerbach, CCH Fed. Sec. L. Rep. ¶93,617, (S.D.N.Y. September 19, 1972). Indeed, this court (Wyatt. J.) in Fogel v. Chestnutt finds Burgin unpersuasive.

Moreover, in view of the developments since Burgin one can be certain that whatever doubts might exist as to whether its basic thrust was non-disclosure, rather than a mandate that regional exchanges be utilized to secure "give-ups" for reduction of management fee, there is little doubt in my mind that non-disclosure is the only precedential value that Burgin now retains.

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III.

In this case it is clear that F. Eberstadt from the very outset of the formation of the Fund took the position that his firm should not involve itself as executing broker for the Fund. The Board's consideration and discussion of the issue of "give-ups" and possibility of recapture were periodic and extensive. That discussion can be physically documented beginning in 1967. M&D sent to the Board on January 9, 1967, a summary of the SEC PPI report. In its memorandum, M&D advised the Board that the SEC "looks with favor on the practice of using brokerage business on portfolio transactions to reduce" management costs, and indicated that brokerage affiliates of two mutual fund organizations had been recapturing commissions on the Pacific Stock Exchange. (Plaintiff's Ex. 74, pp 6-7). Thus, the Board knew then that the current "give-up" practices could be utilized through Eberstadt to reduce management's fee.

On January 26, 1968, the SEC issued a release which dealt with the level and structure of commission rates on the NYSE, reciprocal brokerage and "give-ups." It considered the possibility of commissions being recaptured by the manager through give-ups or by earning the executing commission and applying the "give-ups" or commission to

reduction of the fee. The release proposed adoption of Rule 10b-10 which would have allowed "give-ups" only if recaptured for the benefit of the Fund. The Board received copies of the release and on February 20, 1968, the Fund's counsel, Sullivan and Cromwell, advised the Board in an opinion letter stating in part "assuming that the Board of Directors has considered all the relevant facts ... including the possibility of adopting alternate methods of handling the Fund's brokerage business whereby a portion of the commissions might be used to reduce the management fee, and assuming further that, as a result of such consideration, the Board of Directors has come to the conclusion as a matter of reasonable business judgment" that no change in its current practice be made, that such a course in its view would be lawful. (Plaintiff's Exhibit 75).

The next day, February 21, 1968, Dorsett & Murray, who made up the subcommittee to review the management and distribution agreements with M&D distributed their written report. The report referred to the SEC release and its discussion of the possibility of recapture of commissions through "give-ups" and management receipt of commissions, proposed Rule 10b-10, and the opinion letter of counsel. The report pointed out that the Fund had paid $618,000 in brokerage commissions in 1967; that some $510,000 of this had been allocated to brokers based

on volume of Fund shares sold; that it was a practice of the Fund with full knowledge of the Board and shareholders to use the allocation of brokerage business and [illegible] directed "give-ups" "as additional compensation to dealers who sell Fund shares." It advised no change in the Fund's method of doing business "even though we recognize [the possibility of requesting the manager to act as executing broker or to] request give-ups on portfolio transactions which would be credited against the ... management fee." (Plaintiff's Ex. 76). That same day the Board met, discussed the report, and voted to continue the existing arrangements.

On February 19, 1969, the same subcommittee in its review of the operation of the Fund and the management and distribution agreements filed a written report. The report noted that the subcommittee had again reviewed the basis on which brokerage commissions were allocated and recommended no change. It noted the abolition of "give-ups" as of December 5, 1968, by the NYSE. It recommended continuation of the practice of not using Eberstadt as executing broker even though recognizing that M&D could be requested to use Eberstadt in this capacity. (Plaintiff's Ex. 120). This report was discussed by the Board and it voted to continue existing arrangements.

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The subcommittee report of January 22, 1970 (Plaintiff's Ex. 121) again reviewed and recommended continuation of the current practice of allocation of brokerage business and the policy of not using Eberstadt as executing broker. It recommended that the only restriction on the complete discretion of DSD in the allocation of brokerage commissions be that no change in the policy of not using Eberstadt as executing broker be made "without the specific concurrence of a majority of the unaffiliated directors ". This report was distributed to the directors, and on February 18, 1970, the Board voted to continue its existing practice as to brokerage commissions.

In 1971, the subcommittee report was made by Dr. Murray and Governor Alfred Driscoll and again the subcommittee reviewed the brokerage allocation and the possibility of recapture and concluded it would be inadvisable to alter present arrangements. (Plaintiff's Ex. 122). Again the full Board concurred.

Copies of the decision relied on by plaintiffs here, Moses v. Burgin, were mailed to the Fund's directors on June 4, 1971. At the June 16, 1971, Board meeting a committee consisting of Dr. Murray, Governor Driscoll and Dr. Bertrand Fox, all unaffiliated directors, was appointed

to review again the issue of the Fund's brokerage allocations and various alternatives. After consultation with counsel, the committee recommended no change. At the Board of Directors meeting of December 15, 1971, M&D reported that brokerage affiliates of other mutual funds had been utilizing regional securities exchanges to recapture brokerage commissions and had been applying them to reduction of management fees, and that SEC was expected to announce a position on the question soon. On March 27, 1972, and on January 15, 1973, the subcommittee after review of policy recommended no change. (Plaintiff's Ex. 123, 124). On January 14, 1974, the audit committee consisting of Governor Driscoll, and Messrs. Hobbs and Richard recommended adherence to existing policy. (Plaintiff's Ex. 78).

On the basis of this record, it is clear over the years that the Board's unaffiliated directors have given careful consideration to the issues raised by the plaintiff. The Board has examined the practices each year, noted what methods were available for the Fund to recapture excess brokerage commissions but each time has concluded that it should not do so.

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On March 14, 1972, the articles of incorporation were amended to make specific that the Board had power "to determine ... the manner and purposes of the allocation of brokerage commissions to be paid by the Fund." In the notice of annual meeting [2] distributed in connection with the March 14, 1972, shareholders meeting, it was stated in respect of the proposed amendment to the articles of incorporation that the Board felt it to be in the best interest of the Fund to continue the practice of having all portfolio transactions carried out by brokers not affiliated with Eberstadt and of not making any provision for recapture of commissions through affiliated brokers. The statement also said that the Board had directed the manager not to use Eberstadt as executing broker. (Plaintiff's Ex. 35, p.6).

The notice of meeting stated that this law suit had been instituted and that it "challenged the brokerage

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[2] Plaintiff actually alleges that the proxy statement was false and misleading. No proxy statement was made a part of the record. In support of this allegation and succeeding references to proxy statements, plaintiff cited her Exhibits 28-38, which are the various notices of annual meeting from 1965 to date which enclosed the proxy for the year in question. The opinion, therefore, refers to these notices and modifies the plaintiff's contentions as claiming these notices violated the law.

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practices and the reasonableness of the management fees. *** [and] seeks injunctive relief and damages for the benefit of the Fund." (Id. at p. 10). The amendment was approved on March 14, 1972.

The plaintiff contends that from January 1, 1965 to date, each of the Fund's notice of annual meeting (Plaintiff's Ex. 28-38), Form N-1R and Form N-1Q reports (Plaintiff's Ex. 39-54; 88, 125-127) and prospectuses were materially false and misleading in failing to disclose: that "give-ups" and "reciprocals" were being used to discharge contractual obligations which M&D owed to the Fund under the management and distribution agreements; that the Fund was receiving less than net asset value because excess brokerage commissions were not being used to reduce management and distribution fees, and that prior to December 5, 1968, "give-ups" went to brokers who had no part in execution of portfolio transactions. However, the uncontroverted facts are that during this period, the unaffiliated directors were advised and kept fully abreast of their power if they wished to change existing policy, and of the SEC views and proposals on the issues. The Board voted no change and took full responsibility for the continuation of its policy of not using Eberstadt as executing broker.

Moreover, while the full implications of the policy were not spelled out, the policy was announced to the shareholders in every prospectus issued since 1965. During this period the shareholders have been informed of the Fund's policy of brokerage allocations and of not utilizing Eberstadt in this connection. Its 1965 prospectus stated that the manager places orders for purchase and sale of securities "with dealers where it believes the best execution can be obtained," and that allocation of brokerage business of the Fund was made "partly on the basis of the Fund shares sold and partly on the basis of services rendered." It also stated that the Fund had never utilized F. Eberstadt & Co. as an execution broker but that it might do so in the future but "if so, only in its capacity as broker in respect to transactions on a national securities exchange at regular exchange commissions and charges." (Plaintiff's Ex. 11).

The 1966 prospectus set forth the total brokerage fees paid by the Fund in 1965, indicated how much of that went to dealers based on Fund shares and how much to dealers for providing statistical research and other services to the manager. It further stated that "these services do not reduce the expenses of the [m]anager by

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a material amount"; that the Fund currently intended to continue the same policy of allocation. The statement in the 1965 prospectus in respect of non-utilization of Eberstadt as execution broker was repeated (Plaintiff's Ex. 12). In 1967, 1968, 1969, 1970 and 1971, similar statements indicating how brokerage business was allocated and the same litany as to non-utilization of Eberstadt as an executing broker were repeated in the prospectuses (Plaintiff's Ex. 13, 14, 15, 16 and 17).

The 1972 prospectus changed this statement somewhat because policy had changed. It sets forth the total brokerage fees paid during 1971, indicating that 67% of such fees had been allocated to brokers who sold Fund shares and provided research and statistical information, 20% to those who sold shares but supplied no additional services, and 11% to brokers who provided only statistical and research information. As to all it was said that the brokers had supplied the best execution. It was stated that the Board had directed management not to use Eberstadt as execution broker, and reference was made to SEC's policy statement of February 2, 1972, indicating that reciprocal brokerage as a reward for selling shares should be terminated. (Plaintiff's Ex. 18, p. 10).

OPINION OF THE DISTRICT COURT (CARTER, J.)

The 1973 prospectus stated that selection of brokers "is made strictly on the basis of the value and quality of the brokerage services rendered," set forth the total brokerage commissions paid and as usual asserted that Eberstadt did not participate in the Fund's brokerage business. (Plaintiff's Ex. 19, p. 8).

Plaintiff alleges that the Fund's January 27, 1972, notice of annual meeting was false and misleading. This statement was distributed in connection with a shareholders' meeting of March 14, 1972, convened to vote on the proposed amendment to the Fund's certificate of incorporation authorizing the Fund's Board "to determine in their discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund." The notice represented that the purpose of the amendment was to "make explicit that which has always been implicit" that power to determine how the Fund's portfolio is used rests with the Board. This statement is alleged to be false because "Moses v. Burgin squarely held that directors of the fund lacked that power," and because the real purpose of the amendment was an effort to circumvent Burgin. (Plaintiff's Post-Trial Brief). Suffice it to say that, as already indicated, Burgin for me is clear authority only for the proposition that management in failing to disclose to non-affiliated directors all facts pertinent to their determination of Fund policy acts at its peril.

OPINION OF THE DISTRICT COURT (CARTER, J.)

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IV.

The issue raised here concerns a problem that has long troubled the securities industry. Mutual funds are organized by brokerage firms which become investment advisors to the fund. The fund is a shell, and the advisor provides office space, staff and management services. The advisor or manager decides on investments and acts as distributor or underwriter for the sale of Fund shares. Its function and compensation are determined by contract. It is argued by management that sales must be continuous so that the fund will have on hand sufficient cash to redeem shares. Since the management fee is tied to the size of the Fund, it is usually to management's benefit to encourage sales. In 1966, the Securities and Exchange Commission's report, PPI at 203, showed that redemptions constituted a minor percentage of the Funds assets. The figure ranged from a low of 3.93 in 1953 to a high of 5.43 in 1964; in 1965 the percentage was 5.63. Ibid.

It was early recognized that mutual fund operation creates numerous conflicts of interest when a manager acts as advisor and distributor. These conflicts occur because the opportunity for self-dealing is great. But

these hazards indigenous to mutual funds do not appear to be the problems raised in this litigation. The market performance of the Chemical Fund has been consistently above average when measured against the performance of other funds with similar investment programs and against the performance of the market in general. For example, between December 30, 1968, and November 14, 1974, Dow Jones Industrials registered a 31.5% loss, Standard & Poor's 425 showed a 28.9% loss, while Chemical Fund registered a 0.8% loss. Using the period September 30, 1971, to November 15, 1974, as a basis for comparison, the Fund evidenced the best market performance of some 14 comparable mutual funds, and did better than the general market as evidenced by Dow Jones Industrials and Standard & Poor's 425. When the period December 31, 1973, to November 15, 1974, is used, the Fund again ranks better in terms of performance in general as evidenced by Dow Jones Industrials or Standard & Poor's 425 and ranked sixth in respect of comparable funds. Exhibits showing expenses per dollar of assets for the years 1969-1970 (Plaintiffs Ex. 93-97, Schedule A) demonstrate that the Fund again compares favorably with other comparable mutual funds. Moreover, it is also established that churning is not an issue, since the brokerage

commissions paid by the Fund are below that of the industry as a whole. The parties have stipulated that since prior to 1968 in selecting brokers for the execution of the Fund's portfolio transactions, management's primary concern has been at all times "the price and quality of the execution to be provided to the Fund" (Pre trial order ¶XXII). We have here, therefore, no issue of a manager engaging in any transactions for personal profit, apart from the management fee. Cf. SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963).

When Moses v. Burgin was decided, fixed commissions and prohibition against direct customer rebates were the practice. The institutional funds engaged in huge transactions but quantity discounts were not permitted. Brokerage commissions were far in excess of the costs and reasonable profit on the transaction. Thus "give-ups" came into being. Managers of mutual funds used "give-ups" to reward brokers for statistical and research services. Plaintiff contends that paying others for such services was unwarranted since the contract with the manager required M&D to provide these services at its own expense. Defendants contend that M&D used the research services of others to test the

soundness of its own information. But these practices were done with the unaffiliated directors having all the facts and specifically approving the practice and with full disclosure to shareholders. Since the fundamental purpose of the federal securities laws is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor, and thus to achieve a high standard of business ethics in the securities industry," SEC v. Capital Gains, supra, at 186, it cannot be said that any violation has been disclosed on this record. (Emphasis in the original).

What is involved here is the exercise of a good faith business judgment. On the facts developed before me, I have no basis for finding that the Board failed to exercise such care and diligence in respect of the matters in controversy that careful and prudent men could reasonably be expected to exercise under similar circumstances. See Ballantine on Corporations, §63 (Rev. Ed. (1946)). When questions arose the Board sought and relied upon the advice of counsel which alone is sufficient to free them of liability. See Spirt v. Bechtel, 232 F. 2d 241, 247 (2d Cir. 1956). Nor has any fiduciary obligations of management been breached. The policy of the Board and of Eberstadt from the outset was to seek to keep conflicts of interest in respect

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of M&D as manager and adviser of the Fund and M&D as an Ebershadt subsidiary to a minimum. This poses a real problem in the mutual fund field, see Comment, Duke L.J. 429, 432 (1972); Note, 68 Colum. L. Rev. 334 (1968); Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. of Pa. L. Rev. 1058 (1967).

That what is involved here is not an infraction of federal law but policy and an exercise of judgment is made clear in the February 2, 1972, Special Report by the SEC on the Future Structure of the Securities Market, 137, Part II, Bureau of National Affairs, at page 6:

> "[w]hile the Commission is concerned that the level of commissions be reasonable in all transactions ... obtaining the best brokerage services, not merely the amount of the commission must be the ultimate criterion."

Continuing at page 7, the report describes investment research as "a fundamental element of the brokerage function for which bona fide expenditure of the beneficiary's funds is completely appropriate." The report discusses three types of institutional membership on securities exchanges. Membership on an exchange to be used primarily as a vehicle for recapture of commissions was specifically condemned. It discussed the

question of exchange members engaged primarily in public brokerage but also engaged in money management and performing brokerage for the accounts it manages. It did not condemn the practice of a fund whose manager is affiliated with a broker-dealer who does business with the public and also executes some transactions for the affiliate. The Commission did not condemn this practice, because where the broker-dealer was directly managing and advising, it could carry out transactions for these accounts and the public (pp. 8-9). Commissioner Owens dissented from this portion of the report. Id. at p. 10. He would prohibit institutions doing business through a broker-dealer it controls and broker-dealers from doing portfolio brokerage for accounts it manages. The very policy which the Fund's Board has adopted. See Miller & Carlson, Recapture of Brokerage Commissions By Mutual Funds, 46 NYU L. Rev. 35 (1971).

The unaffiliated directors placed a higher value on having the Fund's portfolio transactions free from any taint of self-dealing by Eberstadt; avoiding an appearance that securities in which Eberstadt has a position were being pushed and in attempting to make certain in appearance and in fact that the investments the Fund makes were based on objective good faith and

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not self-interest of the brokerage firm with which it is affiliated.

A recent amendment, Section 6, Securities Acts Amendments of 1975 (Pub. L. 94-29), to the securities law would appear now to bar Eberstadt from any involvement in the portfolio transactions of the Fund. The plaintiff properly points out that the new amendment applies only after May 1, 1973, and does not affect defendants' liability prior thereto. This, of course, is true. Moses v. Burgin, viewed in the light of the amendment and the modification in SEC approach between 1966 and the present to the question raised here, must be interpreted to accord with decisions holding that a requirement of full disclosure and lack of misrepresentation encapsulates the impact of the federal securities laws. Moreover, the new law undergirds the flooring on which the court's view is based that the Fund policy under attack is clearly an exercise of sound business judgment and outside the reach of the jurisdiction of this court. In summary, I find no basis for liability under either the federal securities law or the common law. Accordingly, judgment is ordered for the defendant.

OPINION OF THE DISTRICT COURT (CARTER, J.)

The above constitutes the court's findings of fact and conclusions of law pursuant to Rule 52(a), F.R.Civ.P.

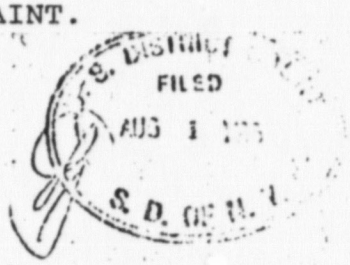
SO ORDERED.

Dated: New York, New York
July 29, 1975

Robert L. Carter
ROBERT L. CARTER
U.S.D.J.

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JUDGMENT DISMISSING COMPLAINT.



UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SUSAN TANNENBAUM Plaintiff	:	71 Civil 2104 (RWC)
-against-	:	JUDGMENT
ROBERT G. ZELLER, FRANCIS S. WILLIAMS, ROBERT C. PORTER, JAMES S. COLES, BURT N. DORSETT, JULIAN M. AVERY, ALFRED E. DRISCOLL, ANDREW W. EBERSTADT, WHITMAN KNOBS, LEROY F. MAREK, JAMES J. MINOT, ROGER F. MURRAY, AUGUSTE RICHARD, BERTRAND FOX, HOWARD A. RUSK, F. SCHNEIDER, ESTATE OF F. EBERSTADT, F. EBERSTADT & CO., INC., F.EBERSTADT & CO. MANAGERS AND DISTRIBUTORS, INC. and CHEMICAL FUND, INC.	:	
Defendants	:	

The issues in the above entitled action having been heretofore regularly for trial, before the Honorable Robert L. Carter, United States District Judge, on December 16,17 and 18, 1974, and stipulation of discontinuance having been signed as to defendants FRANCIS S. WILLIAMS, ROBERT C. PORTER, JAMES S. COLES, BURT N. DORSETT, JULIAN M. AVERY, ALFRED E. DRISCOLL, ANDREW W. EBERSTADT, WHITMAN KNOBS, LEROY F. MAREK, JAMES J. MINOT, ROGER F. MURRAY, AUGUSTE RICHARD, BERTRAND FOX, HOWARD A. RUSK, F. SCHNEIDER, ESTATE OF F. EBERSTADT, and the trial continued as to the remaining defendants, and at the conclusion of the evidence the Court having reserved decision, and the Court thereafter on July 30, 1975, having handed down its opinion, constituting its findings of fact and conclusions of law, in favor of the defendants, it is,

ORDERED, ADJUDGED and DECREED: That defendants ROBERT G. ZELLER, F. EBERSTADT & CO., INC., F. EBERSTADT & CO. MANAGERS AND DISTRIBUTORS, INC., and CHEMICAL FUND, INC., have judgment against plaintiff SUSAN TANNENBAUM, dismissing the complaint.

Dated: New York, N.Y.
August 1, 1975

Robert L. Carter

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NOTICE OF APPEAL.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SUSAN TANNENBAUM, Plaintiff,	:	
-against-	:	71 Civ. 2104 (RLC)
ROBERT G. ZELLER, FRANCIS S. WILLIAMS, ROBERT C. PORTER, JAMES S. COLES, BURT N. DORSETT, JULIAN M. AVERY, ALFRED E. DRISCOLL, ANDREW W. EBERSTADT, WHITMAN HOBBS, LEROY F. MAREK, JAMES J. MINOT, ROGER F. MURRAY, AUGUSTE RICHARD, BERTRAND FOX, HOWARD A. RUSK, F. SCHNEIDER, ESTATE OF F. EBERSTADT, F. EBERSTADT & CO., INC., F. EBERSTADT & CO. MANAGERS AND DISTRIBUTORS, INC. and CHEMICAL FUND, INC. Defendants.	:	NOTICE OF APPEAL

PLEASE TAKE NOTICE that plaintiff Susan Tannenbaum hereby appeals to the United States Court of Appeals for the Second Circuit from the final judgment entered in this action on August 1, 1975, and from each and every part thereof.

Dated: New York, New York
August 27, 1975

Abraham J. Brill
ABRAHAM J. BRILL
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mps TRANSCRIPT.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

SUSAN TANNERBAUM, Plaintiff,	
vs.	71 Civil 2104
ROBERT G. ZELLER, et al., Defendants.	

Before:

HON. ROBERT L. CARTER,
District Judge.

New York, December 16, 1974;
2.15 o'clock p. m.
(Room 506)

APPEARANCES:

ABRAHAM J. BRILL, Esq.,
Attorney for Plaintiff
10 East 40th Street,
New York, N. Y.;
BY: LEONARD I. SCHREIBER, Esq., of Counsel.

SULLIVAN & CROMWELL, Esqs.,
Attorneys for Defendants
F. Eberstadt & Co., Inc.
F. Eberstadt & Co., Managers and
Distributrors, Inc., and
Robert G. Zeller
48 Wall Street,
New York, N. Y.;
BY: MARVIN SCHWARTZ, Esq.,
MARK I. FISHMAN, Esq., and
LAWRENCE W. NELSON, Esq., of Counsel.

WALSH & FRISCH, Esqs.,
Attorneys for Defendant
Chemical Fund
259 Park Avenue,
New York, N. Y.;
BY: E. ROGER FRISCH, Esq., of Counsel.

THE CLERK: Susan Tannerbaum versus Robert G. Zeller and Chemcial Fund.

Is the plaintiff ready?

MR. SCHREIBER: Plaintiff is ready.

MR. SCHWARTZ: If it please the Court, ready for the defendants Robert G. Zeller and the defendants F. Eberstadt & Co., Inc. and F. Eberstadt & Co., Managers and Distributors, Inc., and Robert G. Zeller.

MR. FRISCH: Ready for the defendant Chemical Fund, Inc., your Honor.

THE COURT: Mr. Brill --

MR. SCHREIBER: My name is Schreiber, your Honor. I am counsel to Mr. Brill.

THE COURT: Mr. Schreiber, what about the other defendants?

MR. SCHREIBER: The only individual defendant is Mr. Zeller.

THE COURT: The others are being dropped?

MR. SCHREIBER: That's correct, sir.

THE COURT: Does that include the estate of Eberstadt?

MR. SCHREIBER: It does, sir.

THE COURT: All right, gentlemen. Let us proceed.

MR. SCHREIBER: Your Honor has had our brief, plaintiff's brief?

THE COURT: Yes.

MR. SCHREIBER: May I request that your Honor correct a few typographical errors in the copy of the brief. There are two at page 5 of no great significance, but at line 5 --

THE COURT: Two at page 5?

MR. SCHREIBER: Two corrections at page 5. At the fifth line, "TPI report," the T shoulod be capitalized.

In the next report, the same page, the word "on" should be "or".

The third line of the second paragraph.

THE COURT: Anything else?

MR. SCHREIBER: It would be "or the National Association".

On page 40, which is the last page, in the quotation beginning with the word "Regardless", on the second line, the word "there" should read "these". That is all, your Honor.

Your Honor, would it convenience your law clerk if I were to hand up a second copy of our brief?

THE COURT: All right.

Proceed.

MR. SCHREIBER: Your Honor, do you want an opening statement? I understand your Honor has had and has read the brief or briefs. If you want us to go right ahead, we are ready.

THE COURT: I usually do. In this instance, somehow, the only thing I have -- I have not seen plaintiff's brief. I have read the findings of fact and the memoranda, and I have the complaint and answer, and a short statement, so I suppose an opening statement might be helpful.

MR. SCHREIBER: Very well, your Honor.

This is an action brought by a shareholder of the Chemical Fund.

The Chemical Fund is one of many open-end mutual funds that were widely sold In this country in the past 20-odd years.

A mutual fund, as your Honor doubtless knows --

an open-end mutual fund is one that continuously sells its shares to the public and continues to redeem these shares from the public daily, that is, at any point when you want to buy into a fund, you may do so by paying the net asset value per share of the fund plus a sales commission charge, which, in smaller volume sales, is usually about eight and one-half per cent of the net asset value, and, conversely, when you want out of the fund, all you have to do is to tender your shares to the fund, and you are paid the full asset value without diminution or commission or any other charge.

THE COURT: The point here is that the managers of this fund paid excess amounts for commission?

MR. SCHREIBER: Not excess commission, your Honor, because commission rates throughout the period in question up until 1973 were established at fixed minimums by regulation of the exchanges, and, willy-nilly, that commission to be paid, and no more was paid.

Our complaint is that this fund failed to recapture a portion of those commissions. There were ways in which the net commission could have been reduced through various devices, which might be summarized under the heading of "Recapture".

Let me try to explain that, if I may.

T2 In the period until December 5, 1968, there existed such a thing as give-ups, subdivision 1 under the heading Recapture.

Let me digress first --

THE COURT: What I would prefer, rather than your getting into specific details, give me a brief outline of what the issues are, and then we can proceed, because otherwise you are getting involved in some things that are probably not going to help me at this point.

MR. SCHREIBER: I will not be more than five minutes and this will be helpful to the court. The issue here is really a single issue, the failure of the Fund to recapture a portion of the commissions on portfolio transactions, that is, the Fund paid the established minimum commission, no more, and we say that there were ways in which the Fund could have, and by law should have, recaptured for the benefit of the Fund a portion of those commissions paid on portfolio transactions. What the Fund did was to permit its manager, its adviser and its distributor, the head man on the sale of Fund shares to recapture those commissions not for the benefit of the Fund, but for its own benefit. This, we say, was a breach of its legal obligation, both statutory and common law. This was a way in which an asset of the Fund, the power to recapture, was diverted from the

Fund for the benefit of its adviser, M & D, a defendant in this case, and we say that here, as in the lead case of Moses v. Bergen, cited rather ad nauseam in my pre-trial memo, the managers should be required to disgorge its gain through allocation of these recaptured commissions, should be required to repay to the Fund the amount of commissions which could and should have been recaptured for the benefit b2 of the Fund.

THE COURT: I think that gives me some familiarity with what I am about to hear.

Now, Mr. Schwartz, do you want to tell me the defendants' side of it?

MR. SCHWARTZ: Let me identify first the three defendants other than the Fund involved in this litigation. First, there is F. Eberstadt & Company, which is a member firm of the New York Stock Exchange; second, there is its subsidiary, which we will for shorthand M & D. Its full name is Managers & Distributors, Inc. M & D is the manager or investment adviser of the Fund. And, finally, Mr. Zeller, the only individual served, who is chairman of F. Eberstadt, an officer and director of M & D, and vice chairman and director of the fund.

THE COURT: What position does F. Eberstadt have?

MR. SCHWARTZ: It is a member firm of the New York

Stock Exchange; it's in the general securities business, investment banking, institutional securities business. It does not deal with the public in any retail sense. Its subsidiary, M & D, serves as investment manager for the Fund.

I would like to mention two facts which are stipulated by pre-trial order. Obviously, the Fund's business is the purchase and sale for investment of portfolio securities. The significant issue in this litigation arises from one fact which is undisputed: the board of directors of the Fund have directed that F. Eberstadt, even though it is a member of the New York Stock Exchange, should not under any circumstances ever execute as broker any portfolio transactions for the Fund. What Mr. Schreiber contends in essence is that the directors were wrong, that they should have directed Eberstadt to execute brokerage commissions because if it did there were gimmicks by which some part of that could have been rebated to the Fund in offset to the management fee.

Now, two stipulated facts and then I will sit down and let the witnesses tell the case. It is stipulated in this case that of the 15 directors of the Fund and in all the years in question, 10 of them were wholly and completely independent, were not dominated or controlled by Eberstadt, by M & D, or by anyone else. So our position is that the

decision whether or not Eberstadt should act as a broker was entirely a matter of business judgment to be decided by these independent directors, and once they had done so, the court has no function to perform.

The second stipulated fact and then I will sit down. Mr. Schreiber apparently forgot when he wrote his brief that this was a stipulated fact, the Fund's business is the purchase and sale of portfolio securities for investment, as it is, and it is stipulated with respect to every transaction executed by the Fund during the years in question here, M & D, the manager, sought best execution. There is no quarrel in the case nor can there be under the stipulation which is embodied in the pre-trial order for any argument that M & D favored one broker at the expense of another for its own benefit. It is stipulated that every one of the tens of thousands of orders placed since 1965 was done so in a manner as to get the best execution, that is, the best price, the best terms of execution. With that I will sit down.

I ask your Honor if you would like an extra copy of our brief if yours has been mislaid. We submitted it months ago.

THE COURT: Yes. It seems that between the file room and upstairs we have not received a copy of the pre-trial

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order. I would like a copy of that, if one is available.

MR. SCHWARTZ: I think I have a clean copy for your Honor.

MR. SCHREIBER: My only copy is badly marked.

If I may just reply briefly, true, as Mr. Schwartz said, we do not question but that the Fund did receive best execution, which means the best available price. He over-simplifies, however, when he says this case involves only my contention that Eberstadt could have executed all transactions. Mr. Schwartz omits, not inadvertently, I am sure, to mention the recapture of give-ups, which would have involved no execution on the part of Eberstadt and would have involved merely a bookkeeping transaction by which the fund would have recaptured at least $725,000 in the four-year period from '65 to '68 without any participation in execution whatsoever by Eberstadt.

b3 THE COURT: Now that I am in a frame of reference, why don't we proceed with the trial?

MR. SCHREIBER: Your Honor, we have marked for identification during the course of the depositions some 200-odd documents, of which 160 have been singled out to be marked in evidence here, mostly by plaintiff, some at Mr. Schwartz's request for defendant. We have those 160 documents here. If we may in the interest of saving your Honor's time,

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we will hand them up in bulk at this time, and tomorrow Mr. Schwartz will have available a tabulation which will show as to each of the 160 the prior number in identification, as well as a description of each.

Is that satisfactory to your Honor? We can shortcut an awful lot of time.

THE COURT: Are they numbered?

MR. SCHREIBER: They are already numbered with tabs containing the number.

THE COURT: That is fine.

MR. SCHREIBER: We may use them in the course of the day. May I retain them on my desk, and I now for the record offer in evidence Plaintiff's Exhibits 1 through 160.

(Plaintiff's Exhibits 1 through 160 received in evidence.)

xx

MR. SCHREIBER: Your Honor, we have no witnesses to call for plaintiff's case. We reserve, however, to recall a rebuttal witness or witnesses at the close of the defendants' case. Amongst those we will want to call named in the pre-trial order is a Mr. Dorsett, who testified at the deposition and whose presence I requested of Mr. Schwartz by telephone on Friday. Mr. Schwartz advised me that he would ascertain whether Mr. Dorsett is available. And may I inquire through your Honor whether he will be available for

mmh7

rebuttal?

MR. SCHWART: I inquired of Mr. Dorsett this morning. He advises me that he has to be in Rochester Friday for a meeting he would very much not like to avoid. He is available Thursday afternoon. He won't come in on Friday unless you subpoena him. He won't listen to me. He must attend a board meeting.

MR. SCHREIBER: I am sure he would honor a direction from the court without a formal subpoena. May I request such a direction from the court?

THE COURT: Well, Mr. Schwartz, in the event that you are not going to finish, or it looks that you won't finish by Thursday, is there any way that you and Mr. Schreiber can reach a point that whatever Mr. Dorsett is going to rebut will have been put in evidence so that there won't be any inconvenience?

MR. SCHWARTZ: He has already given a deposition. I won't object to its coming into evidence.

MR. SCHREIBER: In that event, we might have the deposition read into the record.

THE COURT: You are entitled to have him here.

MR. SCHREIBER: I would rather have the body here.

THE COURT: If it can't be worked out I will obviously have to direct him to be here.

mmh8

MR. SCHWARTZ: If I am not finished by Thursday I would be willing to interrupt and put Mr. Dorsett on.

THE COURT: Mr. Schreiber is shaking his head on that. Whatever Mr. Dorsett is going to rebut you will have that in by Thursday? I gather that the plaintiff's position is that you make your case on the 160 exhibits that have been put in evidence?

MR. SCHREIBER: And on the pre-trial order which stipulates certain facts.

THE COURT: All right.

MR. SCHREIBER: It may be that Mr. Dorsett will not be required until Monday. We don't know just when we are going to finished.

MR. SCHWARTZ: May it please the Court, I move to dismiss the case for failure to prove a claim and for failure to prove a federal claim.

THE COURT: Since I have not seen the 160 exhibits, I will have to reserve decision on that.

You may proceed.

MR. SCHWARTZ: Would your Honor like an extra copy of the pre-trial order which I have been able to locate? And tomorrow, since it may be more convenient, we will have another copy of our brief, another set of the pre-trial order and our proposed findings of fact and conclusions of law.

I offer in evidence pre-marked documents A through N, and I offer, if your Honor would like it a list that describes them which I can have tomorrow.

THE COURT: When is it more convenient?

MR. SCHWARTZ: Tomorrow would be more convenient.

MR. SCHREIBER: No objection.

(Defendants' Exhibits A through N received in evidence.)

xx

MR. SCHWARTZ: The defendants call as their first witness Mr. Zeller.

R O B E R T G. Z E L L E R, a witness called on behalf of the defendants, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. SCHWARTZ:

Q Mr. Zeller, what is your occupation?

A I am chairman of the board and chief executive officer of F. Eberstadt & Company. I am only vice chairman and a director of the Chemical Fund and of another fund which we manage called the Surveyor Fund. I am likewise vice chairman of M & D, the subsidiary involved.

Q Is F. Eberstadt & Company now a corporation?

A Yes, it is.

Q And prior to that was it a partnership?

A Yes, sir.

Q Were you associated with that partnership prior to its incorporation?

A Yes, sir, I was a partner from April 1, 1963, until the time of our incorporation, which was November 1, 1969.

Q What did you do for a living before you became a partner of F. Eberstadt & Company?

A I became an associate of the law firm then called Wright, Gordon, Zachary, Parlin & Cahill in 1943; I became a partner of the successor firm, Cahill, Gordon, Reindel & Ohl, as it was then called in 1954 and withdrew from that firm in 1963 to become a partner of F. Eberstadt.

Q I take it then you are a member of the New York bar?

A Have been since 1944.

Q Will you tell the court, Mr. Zeller, briefly and in general terms what is the business of F. Eberstadt & Company?

A F. Eberstadt & Company's business really divides itself into three heads, your Honor: One is the investment banking business -- and I will come back to that -- the other is institutional broker ge business, and I will describe that

a little bit, and the third is money management, and under the heading money management we put our activities into managing the Chemical Fund and the Surveyor Fund, and of recent years, some portfolios, primarily pension funds, b4 institutional portfolios.

The investment banking business is the business of public issue, public underwritings, private placements, work on mergers and acquisitions, financial reports, and studies for a fee, and that kind of thing. That was the original business of F. Eberstadt that Mr. Eberstadt started in 1931.

The institutional brokerage business arises from our membership on the New York Stock Exchange. We did not become a member firm, your Honor, until 1962, just shortly before I went to the firm. We don't doretail business; our business is wholly with the larger institutions, and we get the brokerage business in exchange for the research information on possible portfolio investments which we make available to these institutions.

Q I take it, then, that F. Eberstadt does not do a brokerage business with the general public in the same way that Merrill, Lynch or Reynolds would?

A No, sir, we have no such aspirations.

Q Now, does F. Eberstadt & Company have a subsidiary

known as M & D?

A Yes, sir.

Q What is M & D?

A M & D has management and distribution agreements with the two funds, the Chemical Fund and the Surveyor Fund.

Q Now, focusing upon the Chemical Fund, which is the only fund involved in this litigation, would you tell us in general terms what M & D does for Chemical Fund?

A Yes, M & D for its management fee provide substantially all of the services which are normally provided by a business corporation for itself, for example, we furnish the offices, we furnish the back office work, we furnish the space which the Fund occupies, all that sort of thing is comprehended within the management fee, so that with a very few exceptions the principal expense of the Fund is the management fee.

Those exceptions, your Honor, are such things as franchise, payments imposed directly on the Fund, the directors' fees paid to the unaffiliated directors, and the cost to the Fund of communicating with its stockholders, the reports, that sort of thing, those are borne directly by the Fund. But apart from that we bear the expenses.

We also act as the principal underwriter, as the underwriter of the Fund's shares.

Q Before you come to the underwriting function, let me ask a few questions about the management function. Now, you said that M & D receives a fee for its management services?

A Yes, sir.

Q Could you describe in general terms the structure of that fee, leaving for later consideration the dollar amounts which are in the record?

A Yes, sir. The basic fee up to a billion dollars is .35 of 1 per cent -- it is less than a half of 1 per cent. Now, there is an incentive compensation element in addition depending on what kind of a job we do for the Fund's stockholders. Our compensation can go up by as much as .05 per cent, so it would be a total of .4 per cent. Similarly, it can go down to where it would be .3 per cent. That incentive compensation is based on a comparison of the Fund's performance over a three-year period with the Standard & Poor's 4 to 5 average over that same period.

Q Has the Fund's assets increase over a billion dollars -- Does the percentage rate of the management fee decrease?

A Yes, sir, it does.

Q Turning to the distributor underwriting function, would you describe generally what M & D does?

A Yes, sir. M & D is responsible for the sale of the Fund's shares to make sure there is a constant in flow of cash for investment purposes and to meet redemptions, just as Mr. Schreiber described redemptions, your Honor, Now, the way we do that is that we employ of what are called wholesalers -- I think we currently have nine of them -- who throughout various parts of the country call on the retail brokerage firms, the firms that do business with the public generally, and try to stimulate sales of the funds by those retail firms. As Mr. Schreiber noted, there is a sales charge which goes from 8-1/2 per cent for the small transactions down to one-half of 1 per cent on the largest transactions, and that sales charge is divided with the firm that actually does the retail sales.

Similarly, the basis on which it is divided is a sliding scale, your Honor. To illustate, where the 8-1/2 charge is allocable, the dealer gets 6-1/2 per cent and M & D gets 2 per cent as a way of compensating M & D for the distribution expenses, the salary of the wholesalers, and that kind of thing. On the largest transactions the dealer gets four-tenths of 1 per cent and M & D retains one-tenth of 1 per cent.

Q Is the distribution function performed pursuant to a contract?

A Yes, sir, it is.

Q Is that contract reviewed periodically by the outside directors, the independent directors of the Fund?

A Every year.

Q Similarly, with respect to the management function, is this pursuant to a written contract?

A Yes, sir.

Q Has that contract been submitted periodically to the Fund's shareholders?

A Yes, sir. My recollection is it would average say once every other year, maybe once every third year.

Q How frequently is the management contract reviewed by the independent directors of the Fund?

A Every year.

Q We will come back to that at a later time.

Now I will ask you a few questions about the Fund itself. Could you tell us what its business is?

A It is an open end mutual fund which operates, as Mr. Schreiber described it, and the essential difference, your Honor, between us and most funds is not only our performance, but the field of business in which we invest. Our investments are limited to the chemical process industry, that is to say, businesses which make an important use of the chemical process.

The Fund was founded, your Honor, in 1938, and in the years which have intervened the dividing line between the science of chemistry and the science of biology, the science of chemistry and the science of physics, those dividing lines have become much hazier than they were in 1938, and, consequently, the scope of possible investments of the Fund has increased.

But ours is a fund which is offered to the public as a means of accomplishing two purposes: To give them a means whereby they can invest in high technology industry which they may not feel qualified themselves to try to evaluate, and, secondly, a means of spreading the risk amongst a substantial number of companies. I think the portfolio now numbers somewhere in the eighties, so there is diversification of risk which an investor with a limited amount of funds cannot do.

Q Is the Fund registered with the Securities and Exchange Commission under the Investment Company Act of 1940?

A It is.

Q Wht has been the growth experience of the Fund in recent years?

THE COURT: What is that?

MR. SCHWARTZ: What has been the growth of the Fund in recent years.

A Well, the fund was organized in 1933, with an initial capital of $100,.00, and I think the only stockholders were the directors. By the end of that year the assets under Management had been grown to just a little under $2 million, and we had 9111 stockholders.

Today, the assets under Management are about $706 million, and we have as of Friday, the 13th, 132,059 stockholders, which will give you some idea of the growth.

Q To what, Mr. Zeller, do you attribute the growth of the Fund?

A Primarily to the performance record ofthe Fund. It's been an outstanding record. The annual report, which I think is in evidence, sets forth that.

Very briefly, what you have over this period of years since the Fund has been in existence, the Standard &

Poor's index, which I referred to, your Honor, has increased by 817 per cent. This is as of December 31st last year. And during that same period, a Chemical Fund investor has enjoyed a growth of 1,905 per cent. So that you can see, just looking at it on a straight percentage basis, we have done 133 per cent better than the market as a whole.

Q Mr. Zeller, let me direct your attention to what has been received in evidence here this afternoon as Exhibit K. I believe you have a copy of it. It is the copy of a chart which was submitted to the Fund board at its meeting on November 20th. If you don't have it, I can give you my copy.

A I don't have it. I have a more up-to-date version.

Q Is it correct --

A -- which will be submitted to the Fund's board of directors meeting on Wednesday, your Honor, the day after tomorrow.

Q Is it correct that Exhibit K is a copy of a chart on Fund performance which was presented to the board of Chemical Fund at its last meeting, on November 20th?

A Yes. That's correct.

Q Could you in general terms describe the performance which it depicts?

A Well, what we do as a regular monthly matter, your Honor, to keep the board of directors advised on how well the Fund is doing, is to compare the performance of our Fund against recognized market indices, the Dow-Jones industrials, the Standard & Poor's 425, that I referred to, and, as well, to the comparison of some funds which are like ours aimed primarily at the appreciation of capital and whose performance over a period of time has been comparable to ours. They are the funds with which we thin we are in the keenest competition for the investor's collar.

Now, the comparison is over varying periods of time. There is a comparison from December 31st of the preceding year -- in this case, '73, until, on Exhibit K, November 15th, and, as you can see, nobody has a good performance. Ours, I regret to say, was not satisfactory. It was better than the averages, but I don't regard it as satisfactory.

Now come down to the next column. It compares us over a shorter period with those same funds and with the averages, and then, similarly, a still longer period is contained in the third segment of the exhibit, that being roughly a five-year period.

And I might say, Mr. Schwartz, it is this five-

year chart to which I and the other directors pay the most attention, because we hold ourselves out to the public, and it is a fact that we are not a trading fund. We have low portfolio turnover. Our investments are made for the long haul, and equally our performance is to be judged over the long haul.

THE COURT: Excuse me. So I can understand this exhibit, Mr. Zeller, those figures are percentages growth; is that right?

THE WITNESS: Yes. Percentage of change, really, over whatever the base is.

You see, in that first batch, your Honor, the base is the price or the average, as the case may be, as of December 31, 1973, and, as you can see, we did a little bit better than the averages -- not enough to make me feel that we did a good job.

Now, the next grouping, you see, compares current performance with a base point of September 30, 1971, and, as you can see, particularly in the case of the Chemical Fund, our performance, although unfortunately downward, was still a heck of a lot less downward than the market as a whole.

Then, for the third grouping --

Q Let me be specific about the third grouping,

Mr. Zeller.

Will you look opposite Chemical Fund in the first column at the beginning, 9.505. That is for December 30, 1968. What does that figure mean?

A Net asset value.

Q So each share of Chemical Fund on that date had a net asset value of $9.505?

A Yes.

Q And what is the figure for November 15, 1974?

A $9.43.

Q So on that date, November 15, 1974, the net asset value per share was $9.43?

A That's correct.

Q And the figure in the third column, minus .8: What does that mean?

A It's .8 per cent lower than it was from the base point.

And I might say, your Honor, if we don't get a market turn between now and the end of the year, this will be the first five-year period in Chemical Fund's history where we haven't shown something on the order on a total return basis, both capital gains and ordinary income -- where we haven't shown a gain somewhere in the order of 12 or 14 per cent per year.

Q Now, what would you compare that .8 per cent decline to over that five-year period?

A Well, with say, the Standard & Poor's 425. The Standard & Poor's was off during that same period nearly 29 per cent -- 28.9 per cent.

Dow Jones, which is a more limited index, was off 31-1/2 per cent.

Q Mr. Zeller, do the net asset value figures about which I asked you a moment ago, $9.505 in '68 and $9.43 for November 15, 1974, take into account capital gains and ordinary income dividends during that period?

MR. SCHREIBER: Your Honor, I rise only this once, to make objection, that this entire line of testimony has no relevance to the subject matter of this litigation, which is the failure to recapture commissions on portfolio transactions. That this Fund has grown, either through sales or earnings, or that this Fund has a better or a poorer performance record is utterly irrelevant to the issue here before the Court.

I have no objection to the continued line of this testimony, since we are here without a jury, but I just want to call to your Honor's attention the utter irrelevancy of the entire testimony.

THE COURT: All right, Mr. Schreiber.

Will you proceed, please.

Q Do you have the question in mind, Mr. Zeller?

A I am sorry. I have not.

Q It would probably be quicker to restate it than to have it read to you.

I direct your attention to $9.505 net asset value for December 31, 1968 and the comparison with the comparable figure of $9.43 on November 15, 1974.

Does that comparison take into account dividends paid out during that period from ordinary income or dividends paid out from capital gains?

A Both.

Q They are both taken into account?

A Yes.

Q I have asked you some questions, Mr. Zeller, about the impact of performance, investment performance, upon growth. What has been the impact upon growth of the continuing sale or public offering of the shares of Chemical Fund?

A Well, it's awfully hard to parse it precisely. Perhaps I can answer it this way:

Just a little over a year ago, your Honor, it would have been, say, about the end of October a year ago, the total assets under management in the Chemical Fund

were slightly over a billion dollars. Today, as I indicated, they are around 706, 710 -- right in that range.

Now, during that period, however, we have gone from 114,000 to 132,000 stockholders.

Now, you can add or lose assets by market action alone, but you can't add or lose stockholders by market action. You do that only by sales.

So some indication of the sales success is shown by those figures which I cited to you on the growth and the number of stockholders.

Q Are you familiar with the statistics for the investment company industry in general as they relate to the relationship between sales and redemptions?

A Yes, sir.

Q Since 1970, in general terms, what has been the industry experience?

A Well, the industry during that period of time has almost been consistently in what is called the net redemption position, where redemptions have exceeded sales.

Now, the statistics don't always show that, because the statistics on sales include new funds which are started during the year, and some of these new funds take hold of the popular imagination right away and tend to inflate the sales figures.

To give you an example, during this last yeawr, when short-term interest rates have been at an all-time high, a number of management companies have started what are called money funds.

Q Money market funds?

A Money market funds. And the sales of those have been very rewarding. But they make the case of what I call the ordinary, the long-established mutual fund look very much better than it actually is for the most part.

Our own situation, I am happy to say, has been a very significant departure from that. Last year, that is, for the year 1973, we had the very best sales year that the Fund has ever had, and redemptions, as I recall them -- I can refresh my recollection, if you want them precisely, your Honor, as shown in some of the exhibits -- but redemptions were on the order of only a third of the total sales. We sold last year something like $191 million worth of Chemical Fund. Well, this year, dollar sales were appreciably behind what they were last year, but, interestingly enough, on a per share basis, our sales this year are ahead of last year -- again, the result of market action.

Q What is the expense ratio of a mutual fund?

A The expense ratio is simply a way of comparing

expenses and the way it is computed that the total expenses of the mutual fund, management fee, directors' fees, that I referred to and all other expenses are compared with the total net assets under management, and then that percentage is used as the yardstick to see what the relative costs borne by the various funds are.

Q Is this a yardstick used by the SEC and by analysts generally?

A Yes, sir.

Q How does the expense ratio of Chemical Fund as you find it compare with other funds of comparable size?

A Well, I think you will find it is amongst the very lowest in the industry. Our expense ratio is presently running something like .54 of 1 per cent, and when you realize that the management fee alone for most funds is .5 per cent, you can see that we are operating on a very economical basis.

Q I have one more question to ask on investment performance, which I forgot to ask, having been rattled by Mr. Schreiber's objection.

Does Forbes Magazine periodically review and assess the performance of mutual funds?

A It does.

Q Did it make such an evaluation this year?

A Not only this year but last year. I mention thqt because last year, of all the funds they examined, Chemical Fund was the only fund to get an A rating both in up markets and down markets. This year -- and I think Forbes was right -- the performance of the mutual fund industry generally was so dismal that they didn't make that award. They didn't make that computation, I should say. But I am happy to add that Chemical Fund at least was one of the three funds that were singled out as having done a very much better job than the industry as a whole.

THE COURT: Has that comparison varied very much over the years?

THE WITNESS: Yes. Particularly during the '60's there was what was called the gun-slinging funds, and they did very well for a time, and when things began to change they did not do so well.

Q Turning back to F. Eberstadt & Company, Mr. Zeller, as you testified, it has been a member of the New York Stock Exchange since 1962; is that correct?

A That's correct.

Q Has Eberstadt ever acted as a stockbroker for Chemical Fund?

A Never.

Q Why has it not?

A Because we considered that to do so would place us in a position of conflict of interest, and it was our recommendation to the board of directors consistently, and the board of directors has always agreed with us on this, that it is far better for the Fund to avoid actual or even an apparent conflict, and therefore they have agreed that Eberstadt should not act as a broker for the Fund.

Q Could you tell us in general, Mr. Zeller, how the Fund goes about selecting the brokers whom it employs to execute transactions?

A Yes. The yardstick, the basic yardstick still is who will give us the best execution. Now, there are a number of brokers normally with respect to any particular stock who will fall in that category, all about the same in execution capabilities. Where that is true it has been the practice of the management, spelled out in the prospectus and discussed with the board of directors, to give the brokerage business to those brokers who have rendered some kind of service to the adviser and, more appropriately, to the Fund, doing so through the adviser.

Those services which we took into account over the years were sales, that is to say, who sold most for the Fund; second, who had given us research, which had stimulated our own research, and, third, who had given us

statistical services which we need for the day-to-day operation of the Fund.

Now, since July of 1973, the National Association of Securities Dealers, of which, of course, Eberstadt and M. & D. are both members, has laid down a rule that sales of the Fund should neither be a qualifying nor a disqualifying factor in the selection of brokers, and we follow that, your Honor.

Q What kind of research and statistical services does the Fund obtain through M. & D.?

A Well, in the --

Q From other brokers?

A Well, in the area of research we get from good houses reports, institutional reports, and these institutional reports are never the sole basis upon which a portfolio decision is made. We always, as a matter of pride and a matter of keeping our record good, we never make a portfolio decision unless and until the M. & D. staff has gone over this, and, in the case of a proposed purchase of a company whose stock has not therefore been represented in the portfolio, until and M. & D. staff member has gone out and visited that company and gotten idea of how the management operates and what its research and development programs look like in that kind of thing.

THE COURT: Let me ask you this:

Am I correct in assuming that M. & D., having done the research in regard to investment portfolios of the Fund, then presents that to the company, and a decision is made on that basis?

THE WITNESS: Not quite, your Honor. Almost. Let me explain how we do it.

THE COURT: Well, if you would --

THE WITNESS: I am glad to do it, your Honor.

The M. & D. staff each month -- you see, the board meets monthly, and the M. & D. staff each month prepares its investment recommendation, and that is based, of course, on not only purchases but sales, sales and also on a forecast of whether there are going to be net sales as compared with redemptions and about how much cash is going to be available over the forthcoming month to to invest.

Now, that proposal is presented to a portfolio committee of the board, and the portfolio committee of the board is composed of a majority of outside directors, so-called disinterested directors, as the current statutory expression is.

There are in addition so-called inside directors who sit on that portfolio committee. Mr. Williams, who

is chairman of the Fund, or me, either one of us, we are ex officio members.

Bob Porter, who is president of the Fund, is an ex officio member, and Bob Van Derventer, who is senior portfolio officer, is secretary of the committee.

Now, that committee meets once a month just prior, usually one or two days prior to the board meeting, and the meeting lasts typically all morning long, followed by a lunch. During that time, the staff and the portfolio members exchange -- the portfolio committee members exchange ideas. As a result of that exchange of ideas, what we call an interim investment program is hammered out, where it is proposed to sell so many shares of the securities and it is proposed to purchase so many shares of another set of securities.

That interim investment program -- that proposed interim investment program, because that is what it is at that point, is reported to the full board of directors, and again it is discussed at the board level, and from that, occasionally with changes, the interim investment program for the forthcoming month emerges, and that is followed between the time of that board meeting and the next board meeting.

THE COURT: All right. Thank you.

Q You testified earlier, Mr. Zeller, about the kind of information the Fund receives from brokers through M. & D. Did the information and material so received reduce M. & D.'s operating costs?

A No. It really didn't, Mr. Schwartz. You are recalling an argument which I had with Mr. Eberstadt for years, but I will answer it this way:

In a sense it did not, because, as I said, there isn't any decision, portfolio-wise, that was made ever without work by an M. & D. staff person, including the kind of business that I spoke of. So in that sense, and that was the sense that Mr. Eberstadt always focused on, it didn't save us any money.

On the other hand, there isn't any question but what this outside research information was of great value to us. I mean, it's a different point of view. It's a point of view that's presented by people who are outside the organization. It's a wonderful way of checking the view. And if we didn't have it coming in from the outside, maybe we could buy it; maybe we could add analysts, which I doubt. You wouldn't get the same product. So it's in that sense that I always needled Mr. Eberstadt and said it really doesn't cut down on our expense.

Q As the securities industry is now structured, do you know of any way in which one in the ordinary course would get this outside help except by the allocation of commission business?

A No. Let me turn to a different subject, Mr. Zeller. I will ask you questions about give-ups. Youhave heard the term, I take it?

A Yes, sir.

Q Will you tell the Court what the term means, as you understand it?

A The give-up, your Honor, was a product really of two rules, of the interaction of two rules of the Stock Exchange. One of those two rules was the minimum commission rule, where the same commission rate was charged regardless of whether the order was for 100 shares or 10,000 shares.

Obviously, the costs associated with the execution of the 10,000-share order were not proportionately greater than the costs associated with a 100-share order, so that institutional business was very profitable business.

The other rule which led to give-ups was the so-called no-rebate rule, which is still in effect.

THE COURT: What is that?

THE WITNESS: No-rebate, your Honor. No

rebate.

A (Continuing) And that is the rule which prohibits a member firm from giving back any part of this commission, no matter how profitable it is and no matter how much he would like to do it in order to secure a continued flow of business to the customer who put in the 10,000-share order.

Now, up until -- I think it was December of 1968, the Stock Exchange came close to permitting an avoidance -- maybe you could even use the word "evasion" of that no-rebate rule, and what they did permit was for a customer like Chemical Fund, for example, when it gives a very substantial brokerage order to the XYZ brokerage firm, to direct that a portion of those total commissions be paid over to some other member firm in recognition of the services which that some other member firm had performed for the Chemical Fund.

Q Now, you testified, as I recall it, that this practice stopped on December 5, 1968?

A It was in December.

Q Because of a change of rules by the New York Stock Exchange?

A Yes, sir. Customer-directed give-ups from and after that date were prohibited.

Q Now, going back to the period before December 1968, let us assume you placed an order to buy or sell 10,000 shares of a stock with Merrill Lynch, and let us assume that the total commission was $10,000, that being the minimum commission prescribed by the New York Stock Exchange.

Could you direct Merrill Lynch to pay a part of that to anyone who was not a member firm of the Exchange?

A No.

Q So that you could direct Merrill Lynch to pay a portion of that to some other member firm of the Exchange?

A Yes. Subject, Mr. Schwartz, and the subject is that there were firms -- and I don't remember right now, as I sit here, whether Merrill was one of them -- but there were firms who did not honor these customer-directed give-ups, that is to say, they would not give up any part of their commission to any other member firm.

Q And were there other firms who might under some circumstances pay give-ups but otherwise would not?

A That's right.

Q Now, let us assume for the moment that Merrill Lynch was one of those firms which was amenable to paying those give-ups. I take it that it could only make such a payment to a member firm of the New York Stock Exchange.

A That's correct.

Q And it could make such a payment to another member firm whether or not that member firm participated in the execution of this particular order?

A That's correct.

Q Now, was it the industry practice -- and I mean investment company industry practice -- in the years prior to December 5, 1968, for investment companies to direct executing brokers to give up parts of the commissions they earned in executing mutual fund portfolio transactions to other member firms who had sold shares of the firm to the public or who had supplied statistical advice?

A Yes. It was a useful device from the standpoint of the Fund manager, because if a fund had performed services for you, your Honor, but was not capable in your judgment of giving you the kind of execution you wanted, you could still take care of that firm through the give-up mechanism.

Q Did the give-up mechanism result in any increase in the brokerage commission costs of the Fund?

A No; not at all.

Q And why was that?

A Well, because although the stated commission

schedule of the Stock Exchange was a minimum commission schedule, nobody ever charged more than the minimum, and there was just -- it was a fixed rate business. That's all.

Q Let me turn to a subject other than give-ups, and I will come to them later. I am going to ask you some questions about the Chemical Fund board or directors.

During the period 1965 to 1973, how many members has the Fund had?

A Well, let me start with the current -- the current situation. We have fifteen diectors, a total of 15 directors, and at the present four of those are interested directors, and the balance, the other eleven, are now disinterested directors, so that on the present composition it is something like 73 per cent of our board are disinterested directors.

Q In years '65 to '73, was there ever a time when more than five directors of the Fund were affiliated or associated with either Eberstadt or M. & D.?

A No; I don't believe so.

Q Could you identify the present ten outside directors of the Fund, and not in any kind of long presentation about each but tell the Court who they are and their principal occupation.

THE COURT: Before you go to that:

From 1965 to the present, has the number of directors been the same: fourteen?

THE WITNESS: It's either been fifteen or fourteen, your Honor. I don't think it has varied materially in that time.

THE COURT: All right.

A Well, I will do it in alphabetical order.

First, Dr. James Coles. Dr. Coles had a Ph.D. in chemistry from Columbia College. For fifteen years he was president of Boden and is now president of the Research Corporation.

THE COURT: Well, I don't know if it is necessary to mention him, because he is no longer one of the parties.

MR. SCHREIBER: It presents no problem, your Honor.

A (Continuing) He is a member of the portfolio committee.

Next, Bert Dawson. He graduated from Dartmouth. I might say he is the only three-year varsity letter man we have on the board. Bert's principal qualification, however, is not that but rather his investment background. He was the principal investment officer for the University of Rochester and is now the principal invest-

ment officer for the College Retirement Equities Fund, which is probably the largest equity fund in the country, your Honor.

I think I am right in saying that it is somewhere in the order of three billion dollars. Bert is also a member of the portfolio committee.

Next, Alfred Driscoll. Mr. Driscoll graduated from Williams and then from the Harvard Law School. He was the first Governor of New Jersey to be reelected in a hundred years. After he left the Governorship he became the chief executive officer of Warner-Lambert and built that from a relatively small company into one of the largest health care companies in the country today. He is now retired from that but still busy as the head of the New Jersey Turnpike Commission.

Next, Dr. Bertrand Fox. Dr. Fox got his Bachelor of Arts from Northwestern, Ph.D. from Harvard in economics. For years Dr. Fox was on the faculty of the Harvard Graduate School of Business Administtation. He retired recently as the Jacob Schiff professor of investment banking of that institution. He has also served in a number of consultative capacities with the Government. I remember his best as an expert witness in the Investment Bankers case, which was tried in the late 40's before

Judge Medina. He was an expert witness for the defendants in that case.

Next, Whit Hobbs -- Whitman Hobbs. Bachelor of Science from Harvard, whose entire business life has been spent in the marketing end of things. He was for 16 years senior officer of Benton & Boweles and for years before that an officer of Batten, Barton, Durstine & Osborn.

Next, Lawton Johnson. Johnson had a Bachelor of Science in engineering from the University of Michigan, spent a good deal of time in executive positions with U. S. Steel of an engineering nature and is now chairmna of the board of a firm of management consultants called Panta, Inc.

Next, John Martin, who got out of Georgia Tech, having graduated there with a degree in chemical engineering. All of his business life has been spent with Hercules, which is one of the largest companies in the country, and Mr. Martin is now chairman of the board of that company.

Bradford Mills. Brad went to Princeton, graduated from there, took graduate work at Oxford University in England, was in investment banking business for a time with Eberstadt, back in the 50's, came to the board after having been president of OPIC -- Overseas Private Investment

Corporation -- which was a Government corporation which insured all foreign investors.

Brad did that for a period of four years, and then, as I say, he rejoined us as chairman of our international subsidiary but withdrew about six months ago to become president of his own company, Bradford Ventures Limited, which has the financial backing of one of the largest and oldest aggregations of family wealth -- not Rockefeller -- in the United States.

Next would be Dr. Roger Murray. Dr. Murray has his Ph.D. in economics from NYU. After graduating from college, he was for many years, 1932 to 1955, at the Bankers Trust Company in various investment capacities. I believe I am right that when he retired he was head of all of their institutional portfolios. He left there to go into the academic life. He is now a professor, a Sloane professor of finance at the School of Advanced Business Administration at Columbia, having been engaged in that, I think, really since he left Bankers Trust except for a period of time when he took on the responsibility which Bert Dawson now discharges, that of overseeing the equity investments of CREF, this huge investment portfolio which I mentioned earlier.

Now, next Dr. Howard Rusk, who is a medical

doctor, and he is director of the Institute of Rehabilitative Medicine of NYU. He is probably, at least so far as I am aware, the best known medical man in the country. He is a contributing editor of the New York Times. He is a contributing editor of the Medical News. He has been a valuable member of the board in keeping us in touch with medical developments.

Now, next, Franz Schneider, who is, both in terms of service and in terms of age, our oldest director. Mr. Schneider is the last member of the board who was a member of the board when Mr. Eberstadt started the Chemical Fund, back in 1938.

Franz is a graduate of MIT. He was during the twenty years first financial editor of the New York Evening Post and later of the New York Sun. From there he went to the Numont Mining Company, which was essentially an investment company in the mining industry, and became its executive vice-president and chairman of its executive committee. He is now retired but still serves as a consultant.

Now, during this period, of course, some of the directors who were on in the early part of the period have gotten off, and I might just mention those:

Julian Avery served on the board from 1946 to

1968, graduated from MIT. He was vice-president in research of Research & Development for Diamond-Shamrock and left to become a technical consultant to Standard Oil of New Jersey, now called Exxon, to the Ethyl Corporation, to M. W. Kellogg and Union Carbide. He is an inventor of numerous processes in use in the chemical industry today.

James Minot was on the board from 1938 to 1970. All of his professional life, Jimmy was a partner of Paine, Weber, Jackson & Curtis, the predecessor firm of Jackson & Curtis, and director of many companies. I think he was three times president of the Investment Bankers Association and had a very distinguished career.

Auguste Richard was one of the original members of the board starting in 1938 and served until 1970, with the exception of the war years. Gus was man who was fortunate enough to have a considerable amount of private means. He was always a very substantial private investor of family moneys, and he had a fine Government career. He succeeded Mr. Eberstadt, as a matter of fact, as chairman of the old Army & Navy Munitions Board in World War II, and thereafter for aw period became a partner of Eberstadt & Company, having retired from that capacity in 1954. Gus now describes himself as engaged in civic work, and that is

a pretty good description. That's what he does.

The only other person who was a member during this period who was a member of the board and is not now is Roy Marek. Roy was a graduate in chemical engineering of the University of Texas and got a graduate degree, probably a Bachelor of Science, from MIT, also in engineering. He was a senior vice-president of Arthur D. Little & Company in Cambridge and served on our board as long as we could persuade him to do so.

I think that completes the roster of the outside directors.

Q Thank you, Mr. Zeller,

Now, I am sure you have heard Mr. Schreiber in his opening remarks use the word "recapture", and I am sure you have seen that word innumerable times in the record of this proceeding since it began.

Am I correct that the word "recapture" would involve the use in way or another of Eberstadt Company's seat on the New York Stock Exchange directly or indirectly in the handling of brokerage business for the Fund?

A The answer is yes, with the addendum that we could have done what some firms have done. In order to settle cases like these, they have agreed to take on membership in a regional exchange through an affiliate that does

not have these rebate provisions and have a provision whereby one way or another part of the commiissions can Be taken back by the affiliate and used by the affiliate, or part of them, anyway, in reduction of the management fee. But, directly or indirectly, you are right. It involved the use of Eberstadt as a broker.

Q Now, if Eberstadt acted as a broker for Chemical Fund and executed orders for it on the Stock Exchange to buy or sell portfolio securities, I take it Eberstadt would then be entitled to a commission?

A Yes, sir.

Q And let us assume it was a non negotiated commission, one on which the rate was fised.

A Yes, sir.

Q Now, as you understand the rules of the Stock Exchange -- and if I may be forgiven for leading, because I think this is non-controversial -- as you understand the rules of New York Stock Exchange, would it have been possible over the years for M. & D. to credit against the fee which it charged the Fund for its management work some part of the commissions which Eberstadt received from the Fund on the execution of the Fund's portfolio transactions?

A Not a hundred per cent clear on the rules of the Exchange as written but on the rules of the Exchange

as interpreted by the man on the staff in charge of them, a man named Bishop, the answer is yes, your Honor. Theoretically it could have been done.

Q And was it possible, as you understand it, until 1968 for Eberstadt to demand give-ups or for the Fund to direct executing brokers to direct give-ups to Eberstadt? That would have been possible, would it not?

A Yes.

Q If you found a firm willing to pay the give-up in the first place?

A And if you found us willing to accept them, which we would not have been.

Q Assuming that Eberstadt was willing to receive give-ups and you found an executing firm willing to pay them, could the amounts of the funds so received by give-ups -- or could the amount of the give-ups received by Eberstadt have been offset against a management fee charged by M. & D. in some manner that would not violate the Exchange rules?

A Theoretically, yes.

Q Now, I take it from your previous testimony that the board of directors of Chemical Fund took the position through this period and to the present day that Eberstadt should not under any circumstances act as the Fund's broker

and should not under any circumstances receive give-ups on Fund business; is that correct?

A The answer is yes, and, indeed, for a period prior to the period covered by the complaint.

Q For how long, Mr. Zeller, have you been aware, that is, you personally, that if the Fund directors wanted to, if the Fund directors were willing to and if M. & D. were willing, it was possible to find somehow within the Stock Exchange rules a method whereby Stock Exchange give-ups could be offset against the Fund's maagement fee?

A Mr. Schwartz, you see, there was a period of time in 1962 when I was still a partner of the Cahill firm, and through an arrangement with John Cahill, who was senior partner of the firm -- we were good friends -- I was on loan to Eberstadt at my request to see if I would like the business, and that kind of loan arrangement continued for really, looking backwards, an unduly long period of time, something like five months, as I recall, and it's the best of my recollection that even in the latter part of 1962, when I was over there on a loan basis, this possibility was discussed and discussed with the board.

Q When was it, again, that Eberstadt first became a member of the New York Stock Exchange?

A In the summer of 1962.

Q Is it your recollection that the subject of the possibility of recapture was discussed thereafter -- and let us stop at January 1967.

A The answer is yes. It's been -- it's been a subject which has been reexamined at least once a year, and I think oftener.

Q Now, beginning with January 1967 -- and I will confine my questions to the written record only -- what does the written record show about the frequency with which the Fund's board of directors considered the possibility of using Eberstadt's brokerage seat as a means of recapturing commissions and thereby reducing the management fee?

A Well, if my memory serves me, it was in that time, in January of 1967, when we first began our practice of submitting our -- I mean, M. & D.'s practice -- submitting a written report to a commission committee of the board appointed to consider the question whether the management and distribution agreement should be renewed and report to the full board, and I think it was in 1967 that we first dealt with that in writing.

Now, we dealt with it at least in writing, again, at least yearly thereafter and more frequently, as I recall. For example, this case that Mr. Schreiber likes so much to refer to, this Moses against Bergen, on the

occasion of that case, we immediately circulated that decision amongst the board and considered with our outside counsel, Sullivan & Cromwell, whether this meant that we had -- we were compelled to make a change in our brokerage practices, and that was done, as I recall it, in the middle of the year. T4

So my answer to you, Mr. Schwartz, is, at least once a year.

Q Let me direct your attention, Mr. Zeller, to Plaintiff's Exhibit 74, which is a memorandum dated January 9, 1967. Do you have a copy of it?

A I don't think so.

Q Why don't you take mine?

A Thank you.

Q Is this a copy of a memorandum which M & D prepared for the board of directors?

A Yes, it is a memorandum which I referred to.

MR. SCHWARTZ: Would you like to look at a copy, your Honor? I won't spend much time on it.

Q What was the occasion for this memorandum to the board, Mr. Zeller?

A Well, this is a report put out by the SEC which has come to be known in this case, at least, as the PPI report, public policy implications report, and that report had in it a number of recommendations, some of them for legislation, some of them for changes in the business practice.

I must say that in getting ready to testify here today I was struck by the great discrepancy between what Mr. Schreiber had to say in his brief about the mutual fund industry and what the SEC had to say in this, what was regarded generally as an unfavorable report.

Q I am not asking about that.

THE COURT: I think you better leave to Mr. Schwartz any arguments. We want facts from you.

THE WITNESS: I'm sorry, your Honor. It's easy for me to slip back to an earlier incarnation.

Q Did that report by the SEC, the so-called PPI report, discuss this question of recapture?

A It did.

Q Was that report distributed to the directors of the Fund?

A Yes, sir.

Q Is the document that I have handed to you a summary of the report prepared by M & D for the directors of the Fund?

A Yes, sir.

Q Does that memorandum specifically advert to the possibility of recapture which is discussed in. the report?

A Yes, sir.

Q Now, Mr. Zeller, I will direct your attention to January of 1968 when the SEC proposed the adoption of a new rule, Rule 10(b)(10). Do you recall that proposal sufficiently clearly enough to describe it to the court?

A In general terms it was a proposal which looked toward compelling the kind of an arrangement which Mr. Schreiber contends was compelled all along.

b2

Q And did the SEC put out for public comment a proposed rule 10(b)(10) which would achieve that purpose?

A It did.

Q Was that rule ever adopted by the SEC?

A It was not.

Q When that rule was proposed did the board of the Chemical Fund consult counsel?

A Yes, sir.

Q Did it receive an opinion from counsel?

A It did.

Q Let me show you Exhibit 75 and ask you if that is the opinion which counsel furnished to the board of Chemical Fund?

A It is.

Q It is short and I won't ask you to read it. But what was the substance of the opinion?

A Well, the substance of the opinion was that the board --

MR. SCHREIBER: I must rise to object. The opinion speaks for itself. It is in evidence.

THE COURT: Yes.

MR. SCHWARTZ: May the witness answer, your Honor?

THE COURT: I think Mr. Schreiber is correct. I have a copy of it.

MR. SCHWARTZ: He is technically correct.

Q Let me ask you this question, Mr. Zeller: Did you personally rely on that opinion?

A I did.

Q Do you recall that in November of 1969 the SEC issued another release which was a copy of an opinion by its then general counsel, Mr. Loomis?

A I recall that very well.

Q Let me hand you a copy of release number 8746, dated November 10, 1969. Did you read that release when it was published?

A Yes.

Q Was there any discussion of this release within the Chemical Fund organization?

A Yes, I remember very clearly that Mr. Alfred Jeretski, who was then one of the senior partners of Sullivan & Cromwell, Mr. Stephen West, whom we consulted with on a sort of day-to-day basis, not a partner in Sullivan & Cromwell, and you came over and talked with us about this opinion, and I can remember that there was a certain, shall we say, sense of jubilation on the part of the Sullivan & Cromwell partners in presenting this opinion to us because it did back up the opinion which they had earlier given us.

Q What was the significance of this SEC release to you?

A Well, the significance to me was that the SEC counsel took exactly the same view that our counsel had taken, namely, that it was a question of business judgment through the directors as to whether these brokerage arrangements should be entered into in order to effect recapture of some part of the brokerage for the Fund.

MR. SCHREIBER: I'm going to ask that this document handed to the witness be marked as an exhibit or else not referred to, because the witness in his recent statement, his last statement, is not correctly paraphrasing the document.

THE COURT: It would appear to me that the exhibit would be the best evidence.

MR. SCHWARTZ: I will be happy to offer it as a defense exhibit.

Q Have you finished your answer, Mr. Zeller?

A Yes, sir.

MR. SCHREIBER: Is it received?

MR. SCHWARTZ: I offer it in evidence.

MR. SCHREIBER: No objection.

(Defendants' Exhibit O received in evidence.)

Q The next event I will question you about, Mr. Zeller, is the Moses decision to which Mr. Schreiber referred to.

Assume for a moment that that decision was handed

down on June 4, 1971. At that time were copies of this Court of Appeals decision sent to all the directors of the Fund?

A Yes, sir.

Q Did the directors consider their existing policy with respect to brokerage in the light of that opinion?

A Yes, sir. As I recall it, the committee, which had been appointed before, that is to say, in January of this same year, to consider this question whether the management and distribution should be renewed and whether the brokerage practices should continue, that committee, it seems to me, was enlarged by the addition of Dr. Fox and asked to reconsider the question in the light of this Moses v. Bergen opinion and to consult counsel and then report back to the board.

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THE COURT: Mr. Schwartz, I can go until 5, but if you want to, we can take a short break.

MR. ZELLER: Your Honor, as long as they keep this water glass filled I can go on.

THE COURT: Let's take a short recess.

(Recess.)

BY MR. SCHWARTZ:

Q Have you testified, Mr. Zeller, so far this afternoon that M & D has consistently recommended to the

board that Eberstadt not act as the Fund's broker and that Eberstadt during the period of time when it was permissible prior to the end of '68 not receive give-ups on Fund business?

A Yes, sir.

Q Did you participate in M & D's recommendations to the board in this respect?

A I did.

Q Will you tell the court in your own language and as fully as you can why it was that you and why it was that M & D recommended to the board of Chemical Fund that Eberstadt not act as broker, that it not be used as a vehicle for recapture, and that it not receive give-ups from other brokers on Fund business?

A Let me deal with the direct brokerage question first. When we first became a member firm, the basic reason which led us to make that recommendation was that we did not want after the years that we had had of successfully managing a Fund, to have either a conflict of interest or even an appearance of a conflict of interest with the Fund. And, your Honor, my experience has been as soon as you get on board sides of a transaction there is almost inevitably a conflict.

Let me illustrate the kind of conflict that there

can be, and I have to do it, your Honor, by telling you a little bit about how a brokerage order is actually executed on behalf of the Fund.

After this interim portfolio program that I talked about earlier had been put into effect, that program is then left to the M & D staff to execute, and the fellow in charge of that is John Van Derventer, and John is a senior vice president of the Chemical Fund and has been at Eberstadt since I think about 1951. All of John's time has been spent ever since 1951 on Fund affairs, portfolio affairs, management, administration of the Fund. There is a meeting held once a week of John and the other staff members of M & D, who are active on portfolio affairs at the execution level.

Now, as a result of that weekly meeting decisions are made as to what priorities are to be given in the purchase and sale of securities, and, importantly, what brokers are to be used for the various executions. Then John during the balance of the week carries out the decisions that are reached at that meeting and gives the actual orders to the Fund order room.

The Fund order room gets a very specific direction from John, say, "Sell 10,000 shares of XYZ Corporation," and they also get from John the name of the broker who is to be given that order.

The order room has a direct wire to the floor of the New York Stock Exchange, where most of these things are done. The only significant exceptions, your Honor, are where we can do the trade more advantageously in what is called the third market, with a company like Weeden & Company, for example, that makes a market in New York Stock Exchange listed securities and on a particular day may be offering a shade better price than is available on the floor of the Stock Exchange in this case. We will go to Weeden & Company and do the trade. That is what is called a third market transaction.

Sometimes we do a fourth market transaction. A fourth market transaction is where we happen to know another institutional investor who has a substantial block that it wants to buy of the XYZ Corporation, and if we have, let's say, that 10,000-block share to sell, we will go directly to that other institutional investor and say, "Why don't you buy it from us and save the commission?" But save for that sort of thing, which is not the normal routine, the man who is in the order room, Jimmy Farino will get on the telephone, he will give the order to the floor of the exchange, he will time stamp the time that he gives that order. Then what Jimmy does is to watch that tape and to see what transactions take place after his order is given to make sure

that if it is a purchase, that the trade which has the lowest purchase price is the trade made for the benefit of the Chemical Fund, and if he finds that it is not, when the executing broker reports back then Jimmy's job is to go after him and find out why not. So that in a sense, your Honor, there is always a little bit of the adversary atmosphere, if you will, between the order room and the broker who actually executes the transaction on the floor.

Another illustration of how this conflict can work, and as I have seen it all these years -- I described the process to you by which the interim investment program is hammered out each month, and you will recall that I said it was done in the first instance with the Portfolio Committee. Well, when the staff comes to the Portfolio Committee with a recommendation that a certain security be sold and another security purchased, there has never been implicit in that a concern in the independent directors' minds as to whether we are doing this just to generate brokerage, and it is very important to me that there never be such a concern.

Now, apart from the conflict problem, there is the research and other services which are made available to us, and even though we can't give out brokerage and don't for sales in and of themselves any longer, still a good many of the firms which sell the fund also give us research,

Merrill, Lynch, for example, being a research firm. Now, I would be concerned about the continuance of Merrill, Lynch's sales effort; I would be concerned about whether Chemical Fund was getting first priority on the availability of their research information if there were introduced into the equation this factor, and they would say, "Why do we want to give these fellows this, for, after all, Eberstadt is going to be doing a substantial amount of the brokerage?" That, to my mind, is not good.

THE COURT: The plaintiff is not contending or complaining about the failure of Eberstadt to act as broker.

THE WITNESS: That is the very heart of this case, your Honor.

MR. SCHREIBER: Your Honor, in the period '65 through '68 our complaint is primarily directed to the failure to recapture the give-ups which would not have required Eberstadt to be the executing broker. As to that, and right down to date, plaintiff does say that Eberstadt could have been an executing broker and its profits could have been recaptured by suitable arrangement. There are two facets of the question. Your Honor is absolutely correct in noting that this witness' testimony deliberately ignores the give-ups which would not have required Eberstadt to be an executing broker.

THE WITNESS: May I turn to that, your Honor? I was taking them in order.

THE COURT: Let's continue. I guess I will have to be like a jury and keep an open mind, but I must confess that the reasons given for conflict for Eberstadt not being an executing broker had occurred to me, in any event, and they seemed persuasive. Let's proceed.

THE WITNESS: I would now like to deal with this question of give-ups and why we didn't recommend to the board of directors of the Chemical Fund that we receive so-called give-ups.

In the first place, your Honor, the give-up -- and I hope I have made clear to your Honor what it was -- I think you will see that it was an indirect form of executing the brokerage, participating in brokerage commissions -- I say to your Honor that just there are some firms who executed brokerage for the Fund would not engage in give-ups to others even when they were legally permitted, so I say to your Honor that as the then head of what we call the Policy and Operating Committee of the parent firm, I would not have consented to receive those give-ups, and let me say why. The financial community is a very small community and it's a very gossipy community. Had F. Eberstadt & Company or M & D received give-ups and not been an executing broker,

it would have been subject to either one of two constructions by the financial community, both to the detriment of the firm and the Fund.

The first construction is that we must be doing it without the knowledge of the outside directors. Why else would they not be executing brokerage themselves directly? Why are they resorting to this subterfuge of taking back these give-ups. And even if we could satisfy them on that point, then the competitive position in which Eberstadt & Company, the parent, would have been placed in relation to its institutional brokerage customers would have been terrible. What would happened? Our competitors would say, "The Chemical Fund's directors don't even trust Eberstadt to make direct executions because they can't do it. Instead, the only way they will do it is to let Eberstadt take some give-ups." So I say to your Honor that charged with my responsibilities, I would not have agreed to receive give-ups.

THE COURT: Well, now you are viewing that responsibility in the context in which you are testifying as an officer of Eberstadt, not in regard to Chemical?

THE WITNESS: One other point still exists, and it is a very important point, and that is that at any time Eberstadt profited from portfolio turnover, the atmosphere would have been wrong. Your Honor, as our sales manager put

it to me, we ar the "Mr. Clean" of the industry; we want to stay that way. That was in the interest of the Fund's stockholders as we saw it and see it today, your Honor.

Of course, this give-up has long since gone in the past, but even at the time we didn't want to breach the wall even to the tune of a knot-hole, if you please, that stood between Eberstadt as an executing broker and the Fund.

THE COURT: Well, I am not sure that at the present time I understand this case. I will do my utmost tonight and tomorrow to understand it, and I certainly will. But I think the plaintiff's position is that if the policy had been adopted it would be an offset against the management fee.

Isn't that the plaintiff's position?

MR. SCHREIBER: Precisely, your Honor.

THE WITNESS: I tell you, your Honor, the board never pressed this, to accept give-ups, because they stopped at the threshold. We maintained a complete avoidance of conflict; we want to continue to maintain that. We don't want Eberstadt to do that indirectly. What I say, your Honor, is had they gone further, had they pressed us to accept those give-ups, the determination of the profit on it would have been very difficult, because how much of that give-up should

be used to compensate us for the institutional brokerage that we would have lost in the manner that I have described to you, this impairment of our reputation, and the ability to execute brokerage transactions on a favorable basis.

THE COURT: You are saying if you had participated in give-ups that whatever percentage you would have had returned would not necessarily have been totally offset against the management fee?

THE WITNESS: It could not possibly have been in fairness to us, your Honor, and something would have had to be adjusted; the management fee would have had to be adjusted; something would have had to be adjusted.

THE COURT: Are we going to be able to deal with that?

MR. SCHWARTZ: I suppose that is part of Mr. Schreiber's burden of proof, your Honor.

Q Mr. Zeller, what would have been the effect on Chemical Fund's sales if Eberstadt had acted either as executing broker or had been the recipient of give-ups?

A In the judgment of our sales manager and in my judgment it would have been very adverse.

Q Could you explain why?

A Yes, for the reason that I mentioned before, not only have we sold on the basis of performance, but we have

sold on the basis of our reputation and standing, which for 41 years has been free from the slightest taint. We have 132,000 people who have entrusted us with the management of some part of their funds. That is a great responsibility and we feel it keenly; we want to continue to operate as we have before and so far as humanly possible avoid reflecting adversely on really what you have to sell, which is integrity.

b5 Q To what extent in your judgment would dealers be influenced in recommending the sale of Chemical Fund shares prior to July of 1973 by the fact that some brokerage was being allocated to Eberstadt or that Eberstadt was to some extent participating in brokerage through give-ups in '68?

A It would have affected us adversely. I can't put it in numbers.

Q Now, are sales of mutual fund shares, that is, sales of Chemical Fund shares to the public through independent dealers of benefit to the Fund?

A No.

Q But what they are. History teaches us that.

What is the benefit to the fund?

A Well, first there is what I consider the lesser of the two benefits, and the lesser of the two benefits is as, of course, the asset base expands, the expensive ratio decreases, so that it cost each stockholder less money to

have his money managed. That, to my mind, however, is not nearly as important as the effect of a flow of fresh money on the people who are charged with the portfolio management. It's a matter of record, I think, of historical record, that no fund which has been open end only on one side, that is to say, open end only on the redemption side and which has not had a program of selling, no such fund has ever been successful, even though some of the leading people in our industry have tried to operate such a fund.

The classic example, of course, is the Lazard fund. I don't think there is a better house on Wall Street, a higher quality house than Lazard Freres. And yet when their portfolio people were confronted with the problem of providing funds through disposition of portfolio assets to meet redemptions, they got themselves in a terrible portfolio position, and the performance well, was certainly far from satisfactory. See what it means, your Honor, is if you don't have these funds coming in from sales, you have no option in meeting redemptions but to sell some of your stocks. And that is when the judgment mistakes begin, because sales are made on a forced basis, instead of on a voluntary basis.

Q And your recommendations to the board of directors that Eberstadt not act as a broker, and prior to '68 not participate in give-ups, did you take into account

changes which were anticipated and did, in fact, occur in the securities industry?

A Yes. You see, throughout the period there have been constant new factors introduced bearing on this decision. This proposed rule of the SEC, this 10(b)(10) that was referred to, that was one which caused us to re-examine the policy.

There was a proposal in the senate, your Honor, in legislation, which, as I recall it, at least, got the approval of the senate committee charged with the duty, of advocating or making mandatory -- not advocating -- making mandatory a complete separation of brokerage business from the money management business, and for the very reason-- and it is so stated in the committee's report -- I think counsel can furnish it to you -- a reason, among others, that there is an inherent conflict as soon as the money manager began executing brokerage transactions for the money which it had under management. So there have been a lot of things like that introduced.

I have referred to the conflict of interest problem. The conflict of interest problem, as I have explained it, your Honor, existed at a time when minimum commissions were prescribed for all transactions. In my mind, that becomes an intolerable conflict when you get in the area of

negotiating commissions, where the commissions have to be negotiated out. How can we negotiate with ourselves? It is an impossibility. Now, those negotiating commissions began, as I recall it, in April of 1971. Of course, they were talking of it a good deal before that. As a matter of fact, Mr. Eberstadt, who is one of the most far sighted men I have ever known, saw this as a coming thing in the first days when I went over to Eberstadt. It would make no sense at all for us to embark upon a course of conduct which legislation would compel us eventually to abandon. So all these were factors which were taken into account in our recommendation to the board.

Q I asked you earlier, Mr. Zeller, whether it was your understanding of the rules of the New York Stock Exchange that it would have been and is now permissible one way or the other to offset the management fee with some portion of commissions earned or some portion of give-ups received? Is that correct?

A Yes, sir.

Q Have there been discussions and proposals in recent years to amend the rules of the exchange to prohibit such offsets?

A Yes, sir. Following the Hogen v. Bergen decision, one of the events which transpired is that both Porter and

I went to see Mr. Bishop, who is the vice president of the exchange in charge of member firms, to get clarification on the question, and Mr. Bishop said that under the current rules of the exchange as he interpreted them, that could be done, that is to say, Eberstadt could do some brokerage for the Chemical Fund and employ some part of that in reduction of the management fee, but he pointed out to us that the staff had recommended a termination of those rules, and, indeed, the Board of Governors of the Stock Exchange proposed only last fall, as I recall it, a ruling which would have it perfectly clear that you could not apply any part of the brokerage commission which you got in reduction of the management fee.

Now, I think the Board of Governots retreated from this position, at least so far as I am aware, they never adopted that rule. But it is that kind of a ferment and that kind of cross current as to whether this should or should not be done that we find ourselves operating in.

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THE COURT: One of the things I wanted to have explored -- I'm not sure that I understand it, Mr. Schwartz-- Mr. Zeller has been telling us how this give-up operates. What I would like to know, how does this [illegible] Is that a some agreement that is reached between the brokerage firms? Because I think how these things are consummated and made

have a great deal to do with this. I would like to know some more about that.

MR. SCHWARTZ: We will ask Mr. Zeller about that.

THE COURT: Before you answer, as I understand it, the give-up means that the executing broker is giving up part of his commission? Is that what it means?

THE WITNESS: It means it is an indirect rebate, a kind of indirect rebate, if you will.

As I pointed out earlier, rebates per se were clearly prohibited and always have been by Stock Exchange rules. But here is what would happen. Let me just illustrate it by telling you how a transaction prior to 1968 may have been done.

Chemical Fund would give an order to Paine & Webber and say, "Buy 10,000 shares of Standard Oil of New Jersey." That commission, let's say, would be $5,000 in total. It will say to Paine, Webber, "We want you to give up 20 per cent" -- that was a kind of customary percentage-- "of that commission to Daine, Kalman out in Minneapolis, a regional firm --

Q But a member of the exchange?

A But a member of the exchange.

Now, the reason we would say that is that Daine, Kalman in the days when the so-called reciprocal brokerage

could consistent with SEC rules be used as an additional compensation to the seller of the fund, Daine, Kalman having done a good job selling Chemical Fund, and while we didn't want them to execute the Standard Oil sale because they were not in our judgment as good as it is as Paine, Webber, still we wanted to give them something on this sale that Paine, Webber had done, and that is the way we did it.

THE COURT: The plaintiff is not suggesting that it be done that way; the plaintiff is suggesting that M & D or Chemical Fund should have required or asked the executing broker, Eberstadt, to ask Paine, Webber to give Eberstadt the 20 per cent, which, in turn, would be applied against the management fee of M & D. That, at least, is my understanding. That is not the way you have described it. I suppose what you are describing is some third party that had perhaps performed a service.

THE WITNESS: I think that is right, your Honor, and I must say we never discussed with the exchange, and I don't know to this day the position which the exchange would have taken on that kind of a give-up back to Eberstadt. They might well have said that this is a clear violation of the ante-rebate rule. I just don't know; we have never got to that point.

THE COURT: I now begin to see that the reason

that you gave for the possibility of a conflict of interest and so forth. I'm sorry you have to educate me as you go along.

BY MR. SCHWARTZ:

Q Let me assume the firm of Daine, Kalman in your judgment was incapable of a satisfactory execution, but let's assume it rendered a service to the Fund by selling Fund shares, or rendered a service to the Fund by giving research and statistical information, after December 5, 1968, when give-ups were abolished how could you reward such a firm, assuming you still considered it incapable of satisfactory execution?

A All I can say is we never found an answer to that question.

Q You know of no way in which to do it?

A No, sir.

Q In the period before December 5, 1968, was there any way to reward that firm, Daine, Kalman, except by a directed give-up?

A No, sir.

Q A few more questions and I will have no more for you.

Mr. Zeller, will you focus on the period prior to December 5, 1968, which was the end of give-ups. Are you

generally familiar with how the larger funds in an investment company operate?

A Yes, sir.

Q Are you aware of any fund of significant side which prior to 1968 has as its manager a member of the Stock Exchange and which directed its manager to receive give-ups and credit them against the management fee?

A There is no such case.

Q That you know of?

A That I know of, and I think I would have known of it had there been.

Q Now, to what extent today, Mr. Zeller, do the large funds in the industry seek to recapture part of the brokerage commissions which the funds pay by an offset against the management fee?

A As a matter of fact, Mr. Schwartz, the only ones I know that do it are by and large the firms that have agreed to do it as a result of settling a case like this one, and they do it in very small amounts.

Q Can you tell me in general terms what you understand to be the typical such settlement?

A On a percentage of the total brokerage business done on a regional exchange, and then there is usually a complicated formula for the determination of what the profit

is from that transaction, and then that part of the profit which is agreed on in the settlement is credited against the management fee, all in my judgment, very much contrary to the interest of the stockholders of the fund, because the manager is required to do this even though he can get a better execution on the floor of the exchange or in the third market or in the fourth market in order to comply with the settlement injunction.

Q In 1972, Mr. Zeller, did the stockholders amend the Fund's certificate of incorporation?

A They did.

Q That amendment is already part of the record, but will you explain to the Court briefly what the amendment was and what it's purpose was?

A Yes. Judge Aldrich, of the First Circuit, in his decision in Moses against Bergen used language which made it look as it the directors, because of the provisions of the certificate of incorporation of that Fund, had no alternative but to have the management directly or indirectly execute transactions and thus recapture part of the brokerage to be used in reduction of the management fee.

It was based on Judge Aldrich's understanding of what the requirement in the charter was that the shares be sold at net asset value. The reason was that if you didn't get part of this brokerage back you weren't really selling your shares at net asset value.

Well, we, like every other fund, mutual fund, open-end mutual fund, had a net asset val ue provision comparable to that of the fidelity funds in your corporate charter. We were advised by our counsel, Sullivan & Cromwell, that that did not require a change in our brokerage practices, contrary to Jude Aldrich's opinion,

but that out of an abundance of caution it would be well for us to propose to the stockholders a charter amendment which would make it clear beyond peradventure that the directors did have the discretion and business judgment to exercise in this question of allocation of brokerage and to continue the existing brokerage practices of the Fund.

Such an amendment of the charter was proposed and carried -- I have forgotten what the vote was, but there was no signficant vote cast against it -- nd, as the proxy statement made perfectly clear, it was done out of an abundance of caution and to avoid any contrary interpretation.

Q And did the proxy statement state that the amendment made explicit what had always been implicit before?

A I believe that is what it said.

MR. SCHWARTZ: I have no further questions.

THE COURT: All right.

Mr. Frisch, do you have any questions?

MR. FRISCH: No, your Honor.

THE COURT: All right.

Mr. Schreiber?

MR. SCHREIBER: Your Honor, it is a quarter of five. I could start with some preliminaries with the witness, and then I assume he will be available in the

morning for further cross-examination, but I think it might be helpful if I used up some of the remaining minutes just to lay a background about what we mean by give-ups, and refer to the nature of them and how they came about.

If I may do that, your Honor, then really cross-examine this witness in the morning --

THE COURT: Well, I think that might be helpful. You mean you want to tell me about them rather than ask Mr. Zeller questions? Is that right?

MR. SCHREIBER: Well, I could tell your Honor about them, or I could bring this out through Mr. Zeller. Whatever your Honor thinks would be better --

THE COURT: Let's have it that way.

MR. SCHREIBER: Through Mr. Zeller?

THE COURT: Yes, because in that way I will be getting information from both of you.

MR. SCHREIBER: I think that would be best, your Honor, and with a reading of the brief the matter will become clear.

CROSS EXAMINATION

BY MR. SCHREIBER:

Q Mr. Zeller, I want to direct my questioning to that aspect of recapture of brokerage commissions that existed until December 5, 1968 and was known under the

general label of give-ups and the possibility of recapturing give-ups for the benefit of the Fund.

A "Possibility" I will accept. "Recapture" I will not accept, because to the best of my knowledge no funds did it.

Q Mr. Zeller, let us first define give-ups. You testified somewhat as to the practice under which brokerage was handled. Now, let us talk to how the practice of give-ups was handled.

Where securities in the portfolio are sold, they are sold through a broker known as an executing broker?

A Yes, with the exception of the third market and fourth market transactions.

Q Very good, sir. And by third market you mean the over-the-counter market, do you not?

A That's right.

Q And by fourth market you mean a direct buyer-to-seller relationship, so that there is no broker as an intermediary?

A That's right.

Q So now let us make it very narrow.

Transactions on the New York Stock Exchange -- lest I am in error, I would ask you to confirm that some 80 per cent of the Fund's transactions were transacted on

the New York Stock Exchange?

A That would be about right.

Q About right. Throughout the whole period, 1965 right down to date?

A Overall, I think that would be entirely accurate.

Q Now, getting back to 1965 through 1968, Mr. Zeller, when a Fund chose to purchase securities for its portfolio or to sell securities from its portfolio, it would have an executing broker, would it not?

A Yes, sir.

Q Now, directing ourselves to the New York Stock Exchange, such executing broker would be a member of the New York Stock Exchange, would he not?

A Yes, sir.

Q And he would be paid the standard minimum commission required to be paid under the rules of the New York Stock Exchange, would he not?

A Yes, sir.

Q The particular transaction of purchase or sale would be directed to that New York Stock Exchange executing broker by somebody at M. & D., usually Mr. Van Derventer or somebody under his direction?

A Yes. It is done, Mr. Van Derventer to the

order clerk to the executing broker.

Q Now, if the executing broker -- this is 1965 through 1968 -- were to give up a portion of his commissions, would he be giving them up to someone who had participated in the execution or someone who had not participated in the execution?

A The expression "customer-directed give-up" was generally used, so far as I am aware, in connection with the situation where the person who was the recipient had not participated in the execution.

Q Thank you.

Now, the reason for directing or sending a customer-directed give-up to a non-participant in the execution:

What was that, Mr. Zeller, in 1965 through 1968?

A To reward the recipient for services rendered of some kind.

Q Very good. Services rendered to whom?

A To the adviser and through the adviser to the Fund.

Q The adviser being M. & D.?

A That's correct.

Q Now, let's talk about the kind of services.

Before we talk about that, however, let us continue on that line, and we will get back to the mechanics once again.

The kind of services were, first, sales?

A Yes, sir.

Q M. & D. had a contract with the Fund pursuant to which it acted as the distributor of fund shares, did it not?

A Yes, sir.

Q And pursuant to that contract it received a stipulated amount, a percentage of the selling price of the shares to be paid by the buyer of the shares; is that not correct?

A Yes, sir.

Q Did that contract provide for any additional compensation to M. & D. to be paid by the Fund?

A No. The compensation that was provided for, the amount of the compensation provided for was arrived at by a negotiation process in light of all of the circumstances, including the services which the adviser got from outside sources.

Q Mr. Zeller, my question was, did the contract provide for any payment to M. & D. by the Fund for its sales or distribution services?

A Then my answer to you stands.

Q It did or it did not?

A It did. When you saw that percentage in there, just as when you saw the amount we would be paid for the management, what I am saying to you, Mr. Schreiber, is that that was arrived at in the light of all the circumstances, including the services which M. & D. got from outside services in the industry.

Q Mr. Zeller, I will hand you a copy of the underwriting contract. Will you show me wherein it is there written or is it not there written?

A It is written in the retention percentage.

Q That is, all that is provided is that the seller shall pay M. & D. for the sales: is that not correct?

A My answer to you stands, sir. It is provided in the retention percentage which is arrived at, as all negotiations are that I am aware of, in the light of all of the facts, including the known industry facts.

Q Known industry or not, did the distribution contract provide for any payment by the Fund to M. & D.?

MR. SCHREIBER: I submit, your Honor, I should have an answer to that question.

THE WITNESS: Your Honor, I think I have answered it. I will try again.

MR. SCHREIBER: I submit it is susceptible of a

yes-or-no answer.

THE WITNESS: It is susceptible of a yes-or-no answer, and I answered yes, it is provided for in the contract, and if you ask me where I will tell you again.

Q Very good.

A It is provided in the retention percentage which is specified in the contract.

THE COURT: I think, Mr. Schreiber, I have heard that answer twice, at least.

MR. SCHREIBER: Yes.

Q I hand you Plaintiff's Exhibit 79, management agreement --

MR. SCHREIBER: I am sorry. This is the wrong one, I think. If I may have a moment, your Honor --

Q (Continuing) I show you a typical distribution agreement, part of Exhibit 88. Exhibit (a) to Exhibit 88.

(Continuing) Will you show me the provision to which you refer?

A Yes, sir.

Q Which is it?

A The second sentence of Paragraph (b) -- I am sorry. The second subparagraph (b).

Q Will you read that to me, please?

A "The max imum retail offering price of such

shares shall be equal to the net asset value as described above, plus a commission to be fixed from time to time by the distributor, not to exceed 8.5 per cent of the maximum retail price."

There is another sentence, but that is the key sentence.

Q And who paid that 8.5 per cent?

A The purchaser.

Q Thank you. The purchaser not being the Fund? The Fund was the seller; is that right?

A That's correct.

Q Thank you, Mr. Zeller.

Now, Mr. Zeller, is there any other provision in the contract to which you are referring, by the way, or was that the only provision?

A No. That's the provision.

Q Very good.

Now, Mr. Zeller, we were to the point in the mechanics where you have a give-up being a portion of the brokerage commission paid to the executing broker, which the executing broker is remitting to another broker, also a New York Stock Exchange member, who did not participate in the execution: is that correct?

A Yes, sir.

Q Now, am I correct that this would be handled in a fashion much as follows:

A letter would be sent by M. & D. to the executing broker saying, "Pay off a portion of your commission to Broker X", and a copy of that letter would go to Broker X, saying, "You are to receive from the executing broker a certain number of dollars."

Is that correct?

A That is a way in which it was frequently done. Sometimes it was done by telephone, both ends.

Q And you said that that would reward the recipient sometimes for sales?

A Yes, sir.

Q Sometimes for research?

A Yes, sir.

Q The research product given to whom?

A Given to the adviser for the benefit of the Fund.

Q I see. The adviser being M. & D.?

A Yes.

Q And M. & D. had a contract with the Fund whereby it was to render advisory management services?

A Yes, sir.

Q And it was paid, therefore, a fee based upon net

asset value of the Fund?

A Yes, sir. It was expressed, as it still is today, although the formula is different today from what it was then. It was expressed as a percentage of the total assets under management, the net assets under management.

Q Was there anything in that management or advisory contract that said that in addition to the stipulated percentage of net assets M. & D. should have the right to use a portion of brokerage commissions to pay firms which assisted M. & D. in providing some of the research which by contract M & D was to provide to the Fund?

A There was no such explicit provision in the contract. The provision was implicit in the negotiation of the management fee.

Q The question was, is there anything in the contract?

THE COURT: I think he said that.

MR. SCHAWARTZ: It has been asked and answered.

THE COURT: He answered that, Mr. Schreiber. He said it was not explicit in the contract.

Q Now, Mr. Zeller, was the give-up also used to reward a broker who provided statistical services?

A Yes, sir.

Q Provided them to whom?

A To the adviser for the benefit of the Fund, and the adviser was M. & D.

Q Did the contract between M. & D. and the Fund require M. & D. to render statistical services to the Fund?

A Yes, sir.

Q Was there anything in that contract that explicitly said that in providing those services to the Fund M. & D. may have others provide the statistical services and may reward such others by allocating to them a portion of brokerage commissions on portfolio transactions?

A No, sir.

Q Now, Mr. Zeller, a little while ago, under questioning by my friend, Mr. Schwartz, you said the average rate of give-ups was about 20 per cent.

A That's my recollection as I sit here. I haven't really gone back to dig that out.

Q That is your present best recollection?

A Yes, sir.

Q Let us see if we can help you to refresh your recollection somewhat, Mr. Zeller.

I show you 145, summary of allocation of portfolio commissions, December 1965, and under a caption "Broker" it lists the names of nine brokers, showing commissions credited and breaking those down into the amount retained and the amount given up.

At the same time I will show you the remaining exhibits that show the same information through the period January '66, being Exhibits 146 and 157.

A Well, of course, I will accept what the records show, Mr. Schreiber.

Q I will show you this and ask you:

Would it not be more accurate to say that give-ups were in the range upwards from 50 per cent rather than 20 per cent?

A Well, whatever these documents show they show. All I would point out to you is that how much you could get any executing broker to give up was always the subject of discussion, of course. I mean, some brokers were willing to give up more than others, and, as I pointed out earlier, some brokers were unwilling to give up anything at all.

THE COURT: I think we are going to suspect now unless you have some burning question that you want to have answered right now.

MR. SCHREIBER: I have no burning questions, your Honor. I am perfectly happy to suspend.

THE COURT: As I think you know, I am in Part I, and I believe that we will be able to start at eleven or shortly thereafter.

MR. SCHWARTZ: Your Honor, would you like to be sent to your chambers before we resume extra copies of the trial order?

THE COURT: All right.

Gentlemen, I will give you a little leeway. I will not require you to be here until about 11.15.

MR. SCHWARTZ: May I ask for an estimate of how long Mr. Schreiber expects to take? I have two other witnesses lined up, and I do not like to have them sit unnecessarily.

THE COURT: I must tell you, Mr. Schwartz, I will want to have your witnesses here when it is necessary for them.

MR. SCHWARTZ: That is why I am asking.

THE COURT: Suppose you work that out with Mr. Schreiber.

(Adjourned to December 17, 1974, at 11.15 o'clock a.m.)

WITNESS INDEX

Name	Direct	Cross	Redirect	Recross
Robert G. Zeller	14			

EXHIBIT INDEX

Plaintiff	Identification	In Evidence
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SUSAN TANNERBAUM
vs.
ROBERT G. ZELLER et al.

December 17, 1974,
11:35 A.M.

--

MR. MERCURIO: Your Honor, Mr. Frisch will not be present today. I will appear in his place.

THE COURT: Very well.

MR. SCHWARTZ: May it please the Court, for the Court's convenience, we have prepared a typewritten schedule of the documents which we received yesterday. I must say we have adopted Mr. Schreiber's descriptions as he gave them, and he represents they are correct.

R O B E R T G. Z E L L E R, resumed.

CROSS EXAMINATION CONTINUED

BY MR. SCHREIBER:

THE CLERK: Mr. Zeller, I remind you that you are still under oath.

THE WITNESS: Yes.

Q Mr. Zeller, at yesterday's hearing, we were talking of customer directed give-ups, and I believe you had testified that those were directed to brokers who had not participated in the execution of portfolio transactions.

Am I correct thus far?

A That's almost the definition of customer directed give-ups as I understood the practice.

Q Then the answer is yes?

A Yes.

Q Were the shareholders of the fund --

A May I clarify that answer? Certainly, there is no reason why you couldn't have a customer directed give-up to somebody who hadn't participated in the execution, but that's not the way the expression was used, as I understood it.

THE COURT: I am interested in what actually happened rather than what the definition was. As I gather, in terms of your practice, they were to brokers, were they not, who participated in the execution?

THE WITNESS: I'm sorry, your Honor. I couldn't quite hear it.

THE COURT: All right. I said that therewere some give-ups that you authorized; is that correct?

THE WITNESS: Yes, sir.

THE COURT: And those give-ups were -- we are talking about the practice; I think I am more concerned with that than what the theory is -- in practice you authorized give-ups to brokerage firms that had furnished

services to the fund?

THE WITNESS: That's correct. They were furnished, as I say, to the adviser and through the adviser--

THE COURT: They performed some service for the management?

THE WITNESS: Exactly.

Q Were the shareholders of Chemical Fund ever advised that give-ups were being directed to brokers who had not participated in the execution?

A Certainly. The SEC was, in our reports. I can't remember whether that was specifically stated in the early prospectuses or not. I just don't have those in mind. They will show what they show.

Q Well, Mr. Zeller, if you want to have those in mind, I show you Plaintiff's Exhibits 11, 12, 13 and 14, which are the prospectuses for the years 1965 through 1968, and I ask you whether you can find anything in those exhibits indicating disclosure to the shareholders of the fund that the recipients of give-ups had not participated in the execution?

A As I think about it, I don't think it is necessary to take the Court's time for me to look through it. I don't believe there was any such statement, because it was not considered material. It was simply part of the

brokerage practices of the time, and it was simply a matter of rewarding brokers for services furnished through the adviser, through the management, to the fund. Whether that was done directly through the give-up mechanism we did not consider a material item.

Q Mr. Zeller, the answer is no, they were not so advised?

A Not to the best of my recollection.

MR. SCHREIBER: I move to strike so much of the answer that went on to a long explanation of why they were not so advised.

THE COURT: I don't think it is necessary to strike it. There is no jury here.

MR. SCHREIBER: That is correct, your Honor. Thank you.

Q Now, Mr. Zeller, yesterday --

THE COURT: I am sorry. The exhibits that you showed Mr. Zeller areprospectuses of the fund?

MR. SCHREIBER: They are prospectuses of the fund through each of the years 1965 through 1968. The give-ups terminated in December of 1968, if your Honor recalls.

b2

Q Now, Mr. Zeller, yesterday you said you could have give-ups directed back to Eberstadt and credited against the advisory fee during this give-up period; is that not

correct?

A Consistent with the rules of the Stock Exchange, yes, it was possible.

Q And you indicated that you could do that if you could find a firm who would give up part of its execution commissions?

A Yes, sir.

Q Was that a real difficulty, Mr. Zeller, finding such a firm?

A No. I think most firms were willing to do it.

Q You indicated that Merrill, Lynch would not.

A I didn't say that. I think what I said was that I couldn't remember whether Merrill, Lynch was one of those firms which would or would not.

Q But most of those firms were willing to give up?

A I so testified.

Q Now, you said yesterday, if my notes are accurate, thatthe receipt of give-ups by Eberstadt credited against the advisory fee due M & D would involve the use of Eberstadt as a broker?

A No.

Q It would not?

A No.

Q The give-ups, as you testified yesterday, were given in part--

MR. SCHREIBER: I will strike that, if I may, your Honor.

Q -- were given in recognition of services rendered. Rendered to whom, Mr. Zeller?

THE COURT: I think we already have that.

MR. SCHREIBER: I am pinpointing down to that.

THE COURT: He said that the services were rendered to the adviser and --

MR. SCHREIBER: To M & D.

THE COURT: Yes. We have had that.

Q My question, Mr. Zeller, is did the research services rendered to M & D reduce M & D's costs?

A No. I think I testified about that at some point yesterday. They didn't, in one sense. They didn't, in the sense that they did not relieve us of our self-imposed burden of making sure that every portfolio move had been checked independently by M & D staff people. The outside research was a source of ideas. It was a cross-check, a very important source of ideas and a very important cross-check. In that sense, it did not reduce our expenses, and yet, as I testified yesterday, had we not had this research, we would certainly have had to spend more money.

Whether we could have gotten research no matter how much money we spent in the thing I am not clear on.

Q Well, you certainly would have had to spend more money had you not gotten this research from other brokers who were compensated by give-ups?

A If the additional research could have been gotten by that expenditure of any amount of money, the answer is yes.

Q You discussed yesterday the decision in Moses against Bergen and I believe you testified in response to questioning by Mr. Schwartz that the opinion in Moses versus Bergen, the opinion of Judge Bailey Aldrich left the Fund no alternative but to use the office of the manager to execute brokerage transaction for the portfolio?

A If I said that it was a very great error. I doubt I said it.

Q Was it the opinion in Moses versus Bergen, the opinion of Judge Aldrich --

THE COURT: That is not going to help me. I really am not interested in what Mr. Zeller or you interpret the opinion to be. I have to make that determination.

MR. SCHREIBER: That is correct, your Honor, but as a result of that opinion the witness has testified in a deposition, and the documents indicate, that they proceeded because of that opinion to do certain exploratory work to see whether recapture was feasible.

THE COURT: It seems to me you may ask him what he did as a result of the opinion. But the question you were asking, at least, the way you framed it, is to interpret the opinion. I am not interested in his interpretation.

Q After the rendition --

THE WITNESS: Your Honor, whether consciously or not, counsel is incorrectly summarizing what my testimony was.

THE COURT: That is all right. We have daily copy.

MR. SCHREIBER: If I do so, Mr. Zell er, I assure you it is inadvertent.

Q The opinion of Judge Baily Aldrich was circulated among management?

A Among the management and among the directors.

Q Was there discussion amongst management and amongst the directors of the Fund of that aspect of the opinion which read in part:

"If recapture was in fact practical . . . if recovery was really available to the Fund the directors had no such choice"?

A Yes, sir.

Q Did the management of the Fund, the directors of the Fund in M. & D. thereafter explore the possibilities of recapture?

A No, we didn't explore the possibilities of recapture really except for the visits we told you about. Our primary concern was whether Sullivan & Cromwell's

advice to us was as before, namely, that the directors had the right to make this business decision.

THE COURT: As I understood your testimony yesterday, after that decision and at that point you despite the advice of counsel you amended your charge and made sure that it was clear that the directors were in position to make a business judgment in this regard?

THE WITNESS: Yes, sir.

THE COURT: Have I confused something?

THE WITNESS: No, that is quite correct.

Q Before we proceed along the line that Judge carter has just questioned you about, I would like to ask something about your testimony yesterday.

I believe you said that if Eberstadt received give-ups, the financial community would believe that they were receiving such give-ups secretly without the knowledge of the directors of the Fund? Am I correctly paraphrasing your testimony?

A In think in general, yes.

Q Did they consider disclosing the effect of such give-ups by Eberstadt and the crediting thereof against the advisory fee to the shareholders of the Fund and the community at large?

A Counselor, there was never any discussion

of the effect on Eberstadt of receiving such give-ups. I testified yesterday, and I hope I was clear, that this was something which certainly would have been in my mind had the directors ever gotten to the point where they wanted to discuss with Eberstadt the taking of give-ups, which they never did. They always considered that the reasons for not giving this direct brokerage were equally applicable to the give-ups and, therefore, never discussed with us what would be the effects on Eberstadt.

Q So if I understand you correctly, Mr. Zeller, there was never any discussion about having Eberstadt receive give-ups for credit against the advisory fee?

A No, not at all; absolutely not. What I just testified to was that there was never any discussion with us as to whether there would be any adverse effect on F. Eberstadt & Company, Inc., the parent company, of such give-ups.

There was extended discussion as to whether we should get brokerage either directly or through the give-up practice.

Q Specifically as to the give-up practice, Mr. Zeller, was there discussion as to whether Eberstadt should receive give-ups or have give-ups directed to them to be credited against the advisory fee?

A The very best to my recollection the answer is yes.

Q I will try to refresh your recollect9on if I may, Mr. Zeller, by reading from page 61 of your testimony on August 28, 1974, upon deposition of this action, the foot of page 61:

"Q Was there ever any discussion about such a breach in the wall as you have termed it of accepting give-ups in the legally permissible period and crediting the actual amount thereof against the advisory fee charged by Eberstadt to Chemical?

"A I have no specific recollection of any such discussion.

"Q Specific or otherwise, have you any recollection of any such discussion?

"A I will stand on my previous answer."

Do you recall any such discussion, Mr. Zeller?

A My testimony remains exactly the same:

I have no specific recollection of any discussion. I know that the whole subject was thoroughly aired, and I am sure in the course of that this question of give-ups was gone into.

Q You testified yesterday that if Eberstadt were to become the recipient of give-ups to be credited against

the advisory fee, it would impair their competitive position with their institutional customers because it would create the belief in such institutional customers that the Fund didn't trust Eberstadt to make executions.

Am I correctly paraphrasing your testimony?

A Yes, sir.

Q Wouldn't that belief arise from the institutional investors anyway by reason of the fact that the Fund was not using Eberstadt as an executing broker?

A No, not at all, never has. The best test of that is the way the institutional business has grown for us, and it has grown very satifactory.

Q But the fact is that during the give-up period and right on down to date Eberstadt was not used by the Fund as an executing broker? Is that not correct?

A That is absolutely right.

Q And it was not used for give-ups during the give-up period?

A That is right.

Q Can you explain to me how directing give-ups to Eberstadt during the give-up period would have impaired the appearance of capability of F. Eberstadt to execute portfolio transactions?

A Yes. In the financial community it was widely

known and is today that we have erected this wall between the Fund and Eberstadt as a broker. Now, if there were a direct breach in that wall, that is to say, if we executed brokerage orders for them, that would be perhaps understood and it would do the Fund damage for the reasons that I have already adverted to, and I won't repeat those. But in my judgment as the chief executive officer of the parent company, had the breach been made indirectly there would no longer be the moral justification for Eberstadt not receiving brokerage that there was before; we would be getting the brokerage indirectly, and indirectly in a way which would carry with it, in my judgment, a connotation that the directors had made the determination that we were not capable of executing orders properly.

Q Mr. Zeller, would that apply even though 100 per cent of the give-ups were credited to the Fund?

A Well, that is exactly what my testimony is. If you think that I would ever have agreed to have a hundred per cent of the give-ups credited against the management fee, you are wrong. I would never have agreed.

Q Or any per cent?

A I would have negotiated that percentage with the directors, the outside directors, had they made the determination that doing what you suggest was in the best

interest of the Fund's stockholders. But in so doing I would have insisted that there be some recognition of the injury to F. Eberstadt & Company which I saw and what they were doing.

Q That injury would be the injury occasioned by the receipt of give-ups where you are not doing execution and that would indicate to the public at large that you are not capable of execution and that would create an injury to the good name of Eberstadt, would it not?

A Yes.

Q Now, Mr. Zeller, I would like to ask you during that give-up period was it not the fact that Eberstadt was receiving give-ups on portfolio transactions of institutional clients where it did not participate in the execution?

A Yes, sir, a very large amount.

Q Did it not have the same effect of creating in the minds of the public that Eberstadt was good enough only to receive give-ups, but was not qualified to do execution for its institutional clients?

A Not at all, not at all, Mr. Schreiber.

Q Maybe you would like to explain the difference?

A Sure. There is a great deal of difference between some outside institution with which we have nothing

to do making a decision that the best way to take care of our contribution is by a give-up; there is a great deal of difference between that and a determination by a fund with which we have as close a relationship as we have had for 36 years with the Chemical Fund making such a determination.

Q That outside institution, as you refer to it, was an institution to whom Eberstadt was rendering services by way of research?

A Yes, sir.

Q And was compensating Eberstadt with give-ups?

A Or other brokerage, yes, sir.

Q But was compensating with give-ups?

A Yes, sir. As I say, we were compensated by give-ups in part during the give-up period.

Q That did not create an indication that such institution preferred to let its executions be handled by an executing broker and compensate you only with give-ups? That cast no shadow on the fair name of Eberstadt?

THE COURT: I think that what Mr. Zeller has said, they did not employ the parent company to do the execution, but then made a deal of some kind that they would get the give-up for services, and if Eberstadt was not in position to do the executing, he says that there

is a difference because give-ups were the practice, and, therefore, if some third party decided that they would give a service that had no connection with Eberstadt, they would reward them for these services with give-ups. That is not the same situation. I think that is what he has been saying.

MR. SCHREIBER: May I try a little nuance on your Honor's statement? There is a further point.

THE COURT: What I am trying to find out actually is whether or not I have comprehended Mr. Zeller's position. Maybe I misunderstood.

THE WITNESS: No, sir, you have not misunderstood it.

MR. SCHREIBER: I don't think you have the full purport of Mr. Zeller's position, which is that the Fund, which was very closely allied with Eberstadt and M. & D., if the Fund gave give-ups to Eberstadt for recapture by the Fund but did not give Eberstadt execution, it would indicate to the world at large that the Fund had some reservation about the execution capabilities of Eberstadt.

My question to the witness was directed to elicit whether a like direction of give-ups to Eberstadt by its institutional clients who chose to give them only give-ups, not executions, would not have like effect, and

he said it did not.

Q Mr. Zeller, in response to questions by Mr. Schwartz yesterday you explained at some length the reasons why Eberstadt was not used as an executing broker for the Fund?

A Yes, sir.

Q I believe you mentioned possible conflict of interest, the difficulties of supervision, the need to have available either give-ups or directed brokerage reciprocals for research, for statistical services and for sales -- am I omitting anything of the reasons, Mr. Zeller?

A Only one, and that was the general uncertainty of the time as to whether, indeed, in any circumstances a money manager would be permitted to do brokerage for the funds which it was supervising. That is the only thing you left out.

Q When you were questioned at your deposition, Mr. Zeller, at page 45 and continuing to page 47:

"Q I would gather that those discussions throughout the years resulted in a determination not to use Eberstadt as a broker?

"A Yes.

"Q I would like to know why?

"A Well, by and large the problem as we saw

it was always that if Eberstadt was used there was an inevitable conflict of interest which might or might not either be evil or, at least, be perceived as evil, which is sometimes just as bad.

"Q Where would the conflict exist?

"A Well, for one thing if you increase the rate of portfolio turnover people would immediately say that it is because of Eberstadt wants to make brokerate commissions. Of course, now, the wisdom of that decision is certainly apparent when you have negotiated commissions on higher trades. How you could negotiate with yourself the commissions is something I don't quite understand.

"Q Of course, that was not true at the time?

"A No.

"Q Because in the early '60s and up until comparatively recently there were no negotiated commissions? Is that not so?

"A Right."

I am skipping a question because there was an error in the date transcribed:

"Q Getting back to the earlier period were there any reasons other than the ones you have mentioned, that is, the fear of creating the impression that there were excessive portfolio transactions to generate commissions

to generate commissions for Eberstadt, was there any other reason why Eberstadt was not?

"A Oh, yes. There is an aspect of a larger problem of conflict of interest. We did not want to present Chemical Fund to the public as somebody that was engaged in a situation where a conflict of interest was almost inevitable, and I must say that is something that has been very important to us. It has been a great asset to us.

"Q Is there any other element of conflict of interest that led to the conclusion other than the one that you have mentioned, namely, the fear of generating, being accused of generating too many portfolio commissions to benefit Eberstadt?

"A Well, that was the most obvious one. We were always afraid that there were others that might be apparent to some others that might not be apparent to us.

"Q Do you recall any others that were apparent to you?

"A No."

What has refreshed your recollection as to other reasons since that time?

A Well, you didn't ask me on my deposition whether there were any other reasons. Your questioning related

to other aspects of conflict of interest.

Q At page 45:

"Q I would gather that these discussions throughout the years resulted in a determination not to use Eberstadt as a broker?

"A That is right.

"Q I would like to know why?"

That was as broad as you could get, Mr. Zeller.

A Well, I am sorry. I don't know any responsive answer I could have given to those questions beyond those which I did.

Q Beyond those which you gave yesterday?

A Beyond those which I gave at the time and those which I gave yesterday.

Q Mr. Zeller, the power to allocate commissions, is that an additional resource?

MR. SCHWARTZ: I don't understand the question. I must, therefore, object to it. Unless the witness understands it.

A If I understand it, you are asking me to go back to my previous incarnation and give you a legal opinion.

Q I don't want you to go back to your prior

incarnation, Mr. Zeller, but as an officer of the Fund and M. & D. and Eberstadt, as a man experienced in Wall Street, do you find that the power to allocate commissions has a value?

A Of course.

Q And in a matter of allocating commissions on portfolio transactions in this situation it had a value?

A Yes.

Q And that was an asset?

A Yes.

Q Or a resource, is the way you first called it?

A Right. I will accept that.

Q Whose asset or whose resource?

A Now you are right back in the reincarnation.

Q Well, Mr. Zeller, I'm not asking you a legal question.

Who used this to pay off someone?

A Well, then, that is a different question from what I understood. With the knowledge and consent of the directors the brokerage allocation decisions were made by the manager.

Q And they made the allocations as to give-ups as well?

A Yes, sir.

Q Mr. Zeller, if the entire amount of give-ups had been directed to Eberstadt and completely credited against the advisory fee, there would have been no profit to Eberstadt, of course?

A There would have been a great problem for the reasons I have gone into at length.

Q Profit, dollar profit, I said.

A Oh, I am sorry. I didn't understand, I didn't hear.

Q The answer to that is yes?

A Yes, sir.

Q Why would that have affected Eberstadt's reputation as Mr. Clean?

THE WITNESS: Your Honor, do I have to go through it again? This, I believe, is either the third or fourth time when I will have to give the same answer.

THE COURT: I am going to agree with the witness, even if it is relevant at this point.

MR. SCHREIBER: I will withdraw the question, your Honor.

THE COURT: Gentleman, I am having a grand jury coming down at 12.30, so you willo have to suspend in 15 minutes. But it seems to me what we can do if it is not inconvenient is to take our lunch hour and resume at 1.45?

Is that agreeab le?

MR. SCHREIBER: Certainly.

MR. SCHWARTZ: Yes.

Q Mr. Zeller, I show you the Sullivan & Cromwell opinion of February 20, 1968, which is here, Exh ibit 75. On the second page of the opinion there appears this language:

"On the basis of the above and assuming that the board of directors has considered all of the relevant facts concerning this matter, including the possibility of adopting alternate methods of handling the Fund's brokerage business whereby a portion of the commissions might be used to reduce the management fee, and assuming further that as a result of such consideration the board or directors has come to the conclusion as a matter or reasonable business judgment that it is in the best interest of the Fund and if shareholders that the continuation of the present method of placing brokerage orders and directing give-ups be approved, it is our opinion that such approval would be lawful."

Now, Mr. Zeller, do you recall what relevant matters were considered by the board of directors, other than those which you have heretofore testified to?

A Yes, sir. I believe they can be fair summarized as this:

What use of the brokerage will in the long run inure to the greatest benefit of the stockholders of the Fund.

Those were the relevant considerations. You always came back just to that consideration.

T3

Q Did you consider any alternate methods of handling brokerage which would have enabled recapture?

A Yes, sir.

Q Did you give thought to a preferred rate, non-membership on a regional exchange?

A Yes, sir.

Q What other methods did you consider?

A Some kind of an arrangement directly with F. Eberstadt & Company pertaining to executions on the New York Stock Exchange.

Q And what conclusion did you reach?

A That it would not be to the interests of the stockholders of the fund to change the present brokerage practice.

Q For the reasons that you have testified to?

A Yes.

Q Thank you. I think I may relieve you of that, Mr. Zeller.

MR. SCHREIBER: If I may have just a moment, your Honor.

Q (Continuing) Did you consider the fact referred to at page 6 of Exhibit 74 that "The SEC apparently looks with favor on the practice of using brokerage business on portfolio transactions to reduce the cost of management"?

A Yes, sir. That was written before the Loomis opinion came out, which was put in evidence yesterday.

Q You testified yesterday that proposed Rule 10(b)(10), which would have made mandatory the recapture of give-ups was never adopted?

A Certainly, Rule 10(b)(10) was never adopted. Now, I can't remember its terms as I sit here, counselor. I'll accept your characterization of it --

Q Instead --

A -- for the purpose of answering the question.

Q It became academic, did it not, because of the entire prohibition of give-ups in December of 1968?

A I'm sorry. As I sit here today, I can't remember the inter-action of the two.

Q We can cover that in the brief, Mr. Zeller. I need not trouble you with it.

Do you know of any other fund which has a New York Stock Exchange member as the affiliate of its manager or director?

A No -- no open-end fund that I can -- oh, yes. Of course there are. The answer is yes.

b2

Q Which?

A Oh, I think some of the larger wire houses have started their open-end funds now. I think Shearson-Hammill

has one, for example, and there may be others that just don't come to my mind.

Q Do you know of any that had a New York Stock Exchange member as an affiliate of its manager or distributor in the give-up period up to December 5, 1968?

A I don't know of any.

Q You testified yesterday that the sale of fund shares was beneficial to the fund; is that correct?

A Yes, sir.

Q Would it also have been beneficial to M & D?

A Yes, sir.

Q When fund shares were sold, were portions of the proceeds segregated so as to be available for redemptions?

A Not segregated as such, but they enter into the calculation of about how much of the total fund's assets should be kept in relatively liquid form.

Q There would be more money on hand for that purpose?

A Yes, sir. In other words, if you are in a position of net redemptions, you must provide that liquidity by sales of portfolio securities. On the other hand, if you were, as we were fortunate enough to be, in a position of net sales, why, the money needed to meet redemptions is provided by the incoming cash flow from the sales.

MR. SCHREIBER: May I have a moment to consult,

your Honor?

Q One last line, Mr. Zeller.

You indicated that using Eberstadt as the executing broker might create a conflict of interest, in that Eberstadt could be accused of creating excessive portfolio transactions or churning the portfolio in order to generate excessive commissions for its own benefit.

A Yes, sir.

Q Would that be true even though the profits from such executing commissions were to be credited against the advisory fee?

A In my judgment, yes.

Q Would that possibility of churning not be eliminated because of the portfolio committee, comprised in its majority of independent directors who would supervise and did supervise purchases and sales of portfolio securities?

A Certainly through the mechanism of the portfolio committee there would be a better control on us than there would be on most other managers, but, as I pointed out yesterday in my direct testimony, if we did brokerage, it would introduce an element into the portfolio committee's consideration of our recommendations as to what the interim investment program should be, which is not presently there,

which in my judgment would be a very disturbing element and very harmful to the making of proper portfolio decisions.

Q And the fear was there that if Eberstadt handled executions, the possibility of churning or excessive portfolio turnover would cast a cloud over its position with regard to the fund?

A It would cast a cloud over the fund, over the firm. It was something completely undesirable from every standpoint as we saw it and see it.

Q Do you remember testifying, at page 99 -- and I quote:

"In the special situation of Chemical Fund, operating as it does through the portfolio committee, that the possibility of abuse of brokerage in the sense of, let us say, artificially inflated turnover is not a great possibility."

A That's what I just said. There's a better control over us than there are over most managers because of the operation of the portfolio committee. No question about it.

Q And where you handled portfolio transactions and received commissions on portfolio transactions for institutional clients, was there not a like possibility of a suspicion of churning

A Well, we weren't making the investment decisions for the institutional customers of the brokerage area.

Q No, but you had advisory contracts, did you not?

A That's true.

Q And where you had advisory contracts, you did make investment decisions, did you not?

A That is correct.

Q And where you made such decisions, did you not in some cases handle the execution yourself?

A Yes; we did.

Q And in such cases was there any far or abuse by way of churning or excessive portfolio transactions?

A No, because of the nature of the clients with whom we deal.

To illustrate my answer, we manage the portfolios of several of the operating companies of the American Telephone & Telegraph Company. These are experienced people to whom we report.They know the problems. They deal with the problems all the time. They are perfectly -- they are sensitively attuned -- these are not like members of the investing public who buy mutual fund shares.

Q They are experienced people and would know how to detect and guard against churning if there were any such possibility?

mph7 Zeller-cross

A Yes, sir.

b3 Q Is not the same true of the experienced people who formed the board of directors of the fund and comprised a majority of its board of directors?

A Absolutely, but that isn't the question. You see, what you are asking me now would be comparable if the directors did not get into the investment process until after investment portfolio changes had been made. That's the case of our institutional customers, you see.

What I am trying to tell you, Mr. Schreiber, is that the portfolio selection process in the Chemical Fund is such, and these portfolio decisions are so delicately balanced, that to introduce this question of self-dealing at the point of making these decisions would in my judgment be very bad.

Q Mr. Zeller, the possibility of churning would be even less likely in the case of the fund than in the case of your advisory clients, would it not, because of the direction given to M & D by the portfolio committee at periodic meetings; is that not so?

A No. I really don't think so, because, as I say, you see, our investment advisory accounts maintain that same kind of brake on us after the fact, so to speak. If they for a moment suspected that we were churning their

portfolios, they would have their accounts out in a minute.

Q And the Chemical Fund maintained the same kind of brake on you, even in advance of your portfolio decisions, did they not?

A Yes, sir. That's just right.

Q But whether the brake was exercised before or after in the case of your advisory contracts, Eberstadt was never accused of churning, was it?

A We never have been.

MR. SCHREIBER: Thank you.

I have no further questions, your Honor.

MR. SCHWARTZ: I have a few more questions for Mr. Zeller. Shall I ask them after lunch or now?

THE COURT: Well, you may as well ask them now.

MR. SCHWARTZ: I will not be long, your Honor.

REDIRECT EXAMINATION

BY MR. SCHWARTZ:

Q Mr. Zeller, I am going to ask you a few questions about M & D's distribution or underwriting function for Chemical Fund.

Is the distribution business of M & D for Chemical Fund profitable?

A Generally, no. In the thirty six and a half

years that we have been distributing the fund we have had an operating profit, that is, a profit before taxes, for that operation in only two of those years.

Q Are you familiar generally with how other funds are distributed in the industry?

A Yes, sir.

Q Are you aware of any management company which shows a profit on its distribution function?

A Not as a regular matter. There are none, to the best of my knowledge.

Q Do you know of any large fund today which has a distributor who is not affiliated with its manager?

A No, sir.

Q So that generally speaking is it your understanding that distribution is generally unprofitable?

A That's correct.

Q What is meant by a fund's turnover rate?

A It's the rate of purchase and sales of portfolio securities as compared with the size of the portfolio. The SEC has a formula, which I might say I don't have precisely in mind, for the determination of that portfolio rate turnover, and we are required to report it and have been, right along, each year.

Q How does Chemical Fund's turnover rate in the

years 1965 to 1973 compare with the investment company industry generally?

A It was very much lower than the average. For example, your Honor may recall that there was presented yesterday an exhibit on which we compared our performance with funds which we regarded ourselves as being in keenest competition with. For the years 1971 through 1973, inclusive, our portfolio turnover ratio was 13 per cent for 1971, 10 per cent for 1972, 10 per cent for 1973, and so far into 1974, 3.3 per cent.

Now, the average turnover rate of all of those competitive funds for those same years was 50 per cent for 1971, 46 per cent for 1972, 36 per cent for 1973. They have not yet published their figures for any part of 1974, so that we can't make a comparison there.

Q How does this comparison of Chemical Fund's turnover rate, which shows it to be lower than that of competitive funds, affect the availability of brokerage to dealers who furnish research information or, prior to July of 1973, who sold fund shares?

A Throughout the period covered by this complaint, indeed, throughout the period of Chemical Fund's history, it meant that we, Chemical Fund, have been at a very great disadvantage in getting sales cooperation, research

cooperation, statistical information, because we simply had less brokerage to give out than our competitors did.

This entered very largely into the decision by the board that the brokerage should continue to be used for that purpose. Whether or not direct brokerage to Eberstadt or give-up brokerage to Eberstadt, that didn't, however you do it -- if you reward Eberstadt or put into Eberstadt some part of those brokerage commissions by way of give-up or by way of direct execution orders, you will be reducing the quantum that is available for research, sales, before the NASD change, and statistical information.

Now, whether it was better to use that brokerage for those purposes or whether it was better from the standpoint of the stockholders to use some part of that brokerage to reduce the management compensation payable to Eberstadt was the closest kind of business decision, and it was made in favor of using the brokerage to protect the kind of performance that Chemical Fund has had since its inception.

MR. SCHWARTZ: I have no further questions.

MR. SCHREIBER: Just one, your Honor.

RECROSS EXAMINATION

BY MR. SCHREIBER:

Q You indicated, Mr. Zeller, that in all but two years distribution was done at a net loss to M & D?

A Yes, sir.

Q Throughout the period, did the advisory fee result in a profit to M & D?

A Yes, sir.

Q I read to you from Exhibit 76, which is a report to the unaffiliated directors of Chemical Fund on the management and distribution agreements with M & D, and this report, which is dated February 21, 1968, was signed by Messrs. Dorsett and Murray, the committee of the unaffiliated directors.

I quote from page 2:

b4 "We were not so favorably impressed with the distribution of the fund shares, although the performance has been adequate in sustaining the fund's investable funds. The losses sustained in distributing shares are, we think, an appropriate incentive of a different kind to encourage the devising of a more efficient effort. We believe that such losses are a proper offset to the profits derived from the management functions."

Did you agree with that report when rendered?

A Well, I certainly agreed that operating losses were an incentive to us to do better, and I certainly agreed

with it so far as it said that the operating losses that we had in distribution had to be compensated for out of the management fee.

Q And --

A There is no other way to do business.

Q That is, when there were sales of fund shares with the greater number of shares outstanding and hence the greater asset value of the fund, the advisory fee went up?

A That's right.

Q So that the sale of fund shares was a direct benefit to the adviser?

A Yes, sir.

Q And if the adviser, M & D, as distributor, lost money on distribution but gained through increase in the advisory fee, one could be an offset to the other?

A Yes, except that you have got to keep in mind that at the rate we are talking about, I have forgotten -- I think a dollar of expenditure for sales expense takes something like 15 years to recover in increase in the management fee. It is a very extended period of time.

MR. SCHREIBER: Thank you. No further questions.

THE COURT: If this has been set forth in the exhibits, then, gentlemen, will you tell me, but I would

like to ask these questions.

I am not clear on what basis was the fund paying M & D a fee. Was it a flat rate, or how was it arrived at?

THE WITNESS: Your Honor, you have to divide it into two periods. During the early part of the period covered by the complaint we had what I would call a straight tapered fee. That is to say, it was a fee which was expressed as a percentage of assets under management, and the percentage went down as the assets went up.

Then, if memory serves, I believe it was in 1970 that the fee was changed, that the fee structure was changed, and we went on to the present fee, substantially on to the present fee. There have been a number of minor changes, where there is a flat percentage charge up to the first billion dollars of .35 of 1 per cent, and then, depending on the performance of the fund, that can go up as high as .4 of 1 per cent.

THE COURT: I see.

THE WITNESS: Similarly, if the performance is not good, the management fee can go down an equal amount, namely, to .3 of 1 per cent.

THE COURT: That is the total compensation?

THE WITNESS: Yes.

THE COURT: Now, Mr. Schreiber raised the question about advisory contracts, and I gather that M & D received compensation for that. Did that have anything to do with the fund that was independent --

THE WITNESS: No, sir. The investment advisory department -- that's a relatively new activity with us; it is not carried on in M & D at all; it is carried on in the parent corporation.

THE COURT: I see. Now, two more questions. As I understand your testimony, you cannot be specific about it, but you indicated that the procedure by which you handled the brokerage fee give-ups was discussed and adopted by the board and rediscussed from time to time, and the board of directors were aware of what was going on, and, if I understand your testimony, it is that from time to time they would manifest their approval by various communications; is that right?

THE WITNESS: Yes, sir. That's absolutely correct.

THE COURT: Now, what about the shareholders?

THE WITNESS: The shareholders were also told what the brokerage practices were, your Honor.

THE COURT: And where would I find that?

THE WITNESS: It is certainly in the prospectus.

THE COURT: When did you start telling that? At

the inception of the practice, was it in any prospectus?

THE WITNESS: Well, the contents of those prospectuses changed, and I can't recall --

THE COURT: Well, certainly for the period when the give-ups were allowable. Were the shareholders advised that it was not your practice to allow give-ups to the parent company?

THE WITNESS: No; there were not, your Honor, for the very reason that I say this morning, that the question was really whether any brokerage revenues flowed to the parent corporation, you see, and whether they flowed by any give-up or direct order was not considered either by us or our counsel to be sufficiently material to be put in the prospectus.

You see, as long as we weren't getting brokerage, there was no disclosure problem. That was our judgment and the judgment of our lawyers. Had we gotten brokerage, then you would have had to disclose that.

THE COURT: I see. So that am I to understand, then, that insofar as the shareholders were concerned, your procedure in respect to the procedure that you have here was not specifically revealed to shareholders?

THE WITNESS: Well, sir, there came a time, as I said, when we changed the approach in the prospectus and

certainly in the prospectus statement which was sent out in connection with that amendment to the certificate of incorporation.

That certainly spelled it out in great detail. Then, as I say, there came a time--

THE COURT: That came on the heels of Judge Aldrich's decision?

THE WITNESS: That's right. There came a time when we changed the prospectus and put in language, your Honor, to cover that, and I am looking at the current prospectus, which I know is an exhibit in the case.

THE COURT: Which prospectus is that?

THE WITNESS: The one I have is the prospectus dated April 30, 1974. That is our current prospectus. Now, there is a section which deals with this question of portfolio brokerage and turnover, and I will just quote one sentence, your Honor:

b5

"The total brokerage commissions incurred by the fund in 1973 were $1,291,735. F. Eberstadt & Co., Inc. and its affiliates do not participate in the fund's brokerage."

Now, I can't remember whether that sentence or an equivalent pair of sentences was in all the prospectuses.

MR. SCHWARTZ: I can answer, your Honor, on the basis of the record. That statement has been in every

prospectus in the record, and I've got it back to '67, that Eberstadt does not act as a broker.

MR. SCHREIBER: That is correct, your Honor. Another aspect the witness has previously testified to: That in no prospectus nor in any other document was it ever indicated to the shareholders that give-ups were directed to brokers who did not participate in -- in the execution of portfolio transactions.

THE COURT: All right. Since we have taken an additional 15 minutes, we will resume at 2 o'clock.

(Witness excused)

THE COURT: Mr. Schwartz and Mr. Schreiber, I have not been able to reach that point yet, but the name Eberstadt seems to have struck a bell with me.

Now, is Walter Eberstadt connected with them at the present time?

THE WITNESS: There is a Walter Eberstadt, but he is not connected with our firm. I believe he is a partner in Lazard Freres.

MR. SCHWARTZ: He was at Lazard and is now with Motorola. I know the gentleman.

MR. ZELLER: He is not connected with us.

MR. SCHWARTZ: Nor is he related.

THE COURT: All right. That is a relief, too.

mph19

MR. SCHWARTZ: I know him quite well.

Anything else, your Honor?

THE COURT: No. That is all.

(Luncheon recess.)

AFTERNOON SESSION

(2.00 p.m.)

THE COURT: You may proceed.

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ROBERT M. MAYNARD, called as a witness on behalf of the defendants, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. SCHWARTZ:

Q Mr. Maynard, what is your occupation?

A I am a partner in Price, Waterhouse & Company, a firm of independent accountants.

Q Do you work out of that firm's New York office?

A I do.

Q Are you a Certified Public Accountant?

A I am

Q In the State of New York?

A In the State of New York.

Q Is Price, Waterhouse & Company the auditors for the Chemical Fund?

A Yes.

Q Are they al so auditors for F. Eberstadt & Company?

A Yes.

Q And for M. & D.?

A Yes, sir.

Q What is your connection with Price Waterhouse as it relates to the Chemical Fund?

A Since 1964, July 1, I have been the partner in charge of the audit of the Chemical Fund, of F. Eberstadt & Company, Inc., and of F. Eberstadt & Company Managers & Distributors, Inc.

Q Will you state yout experience as it relates to the auditing of investment companies?

A In addition to the audit of Chemical Fund, I have been in charge on the same basis, in the same capacity for the Surveyor Fund, which was formerly the Eberstadt Fund, and for other investment company clients of our firm.

I have consulted many times with other partners of the firm concerning their investment company clients. In addition, I have been since 1966 on the AICPA committee on investment companies.

Q What is the AICPA?

A American Institute of Certified Public Accountants.

From 1969 till 1973 I was chairman of that committee, and during the entire period of service on that committee we consulted frequently with industry groups in the investment company industry, with members of the

staff of the Securities and Exchange Commission. Those latter discussions resulted in several instances in the issuance of offical releases by the Securities and Exchange Commission on accounting and auditing matters relating to the investment company industry.

In 1973 that committee which I chaired issued a 150-page booklet entitled Audits of Investment Companies, which had to do with generally accepted accounting principles and generally accepted auditing standards as they relate to investment companies.

Q Are the rules of the Securities and Exchange Commission which governs the record keeping and the financial statements of investment companies?

A Yes.

Q Are you familiar with those rules?

A Yes.

Q Is there a rule of the Securities and Exchange Commission which requires daily calculation of net asset value?

A Yes, sir, there is.

Q Is that Rule 22(c)(1)?

A That is correct.

Q Are you familiar with the rule?

A I am.

Q Is there another rule of the Securities and Exchange Commission which specifies the manner in which net asset value is to be computed?

A There is.

Q Is that Rule 2(a)(4)?

A That is correct.

Q Are you familiar with that rule?

A Yes, I am.

Q How frequently does Price Waterhouse audit the financial statements of the Chemical Fund?

A We make examinations as of the end of June and the end of December every year.

Q In the regular course of those audits in the years '65 through '73 did Price Waterhouse examine the methods which were employed by the Chemical Fund in the computation of daily net asset value?

A Yes, sir, we do, both at June 30 and December 31 in each year and at other dates during the period covered by our audit.

Q In each of the years 1965 to 1973 in the course of your twice annual audit did you reach a conclusion as to whether net asset value at Chemical Fund had been computed in accordance with the rules of the Securities and Exchange Commission?

MR. SCHREIBER: Your Honor, if this witness is to testify as to what he or his firm did, I, of course, have no objection. If this witness is purporting to testify as an expert, then I must, of course, object, because he is the regular auditor for these companies, his firm has put its stamp of approval on what was done, it has certified the statements, and now as a purported expert he would say, "In my expert opinion what we did was correct."

I submit that is not a proper function of a regular auditor of a company.

MR. SCHWARTZ: So far, may it please the Court, I have asked the witness only about facts, what was done and what conclusions he has reached. I propose before he leaves the stand to ask him one or two questions which would relate to his expert judgment, but based upon what he learned In the course of his audits. Anything, such as Mr. Schreiber suggests, is totally without substance, since it would go to the weight, in any event, and not to the qualifications of the witness.

When the day comes when a partner in Price Waterhouse cannot give an expert opinion, I would have grave concern.

MR. SCHREIBER: I think that day has come as a

matter of law, but I have no objection to this witness testifying as to what he himself has done or what was done under his supervision.

THE COURT: So far that is all he has been asked.

MR. SCHREIBER: We are approaching the realm. That is why I wanted to add my word of caution.

Q You said a moment ago before Mr. Schreiber objected that you had reached the conclusion, had you not, as to whether or not the manner in which Chemical Fund's daily net asset value was computed and whether or not that was computed within Securities and Exchange Commission rulings?

MR. SCHREIBER: That is why I rose at this point. That is a question calling for expert testimony.

THE COURT: Whether they had computed net asset value in accordance with SEC rules?

MR. SCHREIBER: That is correct.

THE COURT: As far as Mr. Maynard is concerned, I would think the real question he is being asked, in his analysis of the records of Chemical Fund is it his opinion.

MR. SCHREIBER: There is no question he put his stamp of approval on it. Does he now say, "What I did as auditor I now say as an expert is the way it had to be done"?

THE COURT: He didn't ask whether it had to be done; he asked whether it had been done in accordance with Securities and Exchange Commission rules, and that is a question of fact. I think I agree with Mr. Schwartz that the fact has to be determined whether Mr. Maynard's self-interest is such as to disregard his opinion, if I have to reach that. The objection is overruled.

You may answer the question.

Q Do you have the question?

A Yes, sir, I believe I do.

We concluded that the computation of daily net asset value of the Chemical Fund during that period under review had been made in accordance with the requirements of the Securities and Exchange Commission.

T2

Q And was this a conclusion you reached twice in each of the years 1965 through 1973?

A That's correct, sir.

Q Now, in those years did you reach any conclusion with respect to whether the manner in which asset net value was computed was in accordance with generally accepted accounting principles?

A Yes, sir.

Q And what conclusion did you reach?

A The conclusion was also that the computation of net asset value of the fund was in accordance with generally accepted accounting principles.

Q And was that a conclusion that you reached in each of the years 1965 through 1972?

A Yes, sir.

Q Mr. Maynard, I have furnished you with a copy of the pre-trial order in this case, and I direct your attention to paragraph 13, which shows the management fees paid by Chemical Fund to M & D for each of the years 1965 through 1969, and I have directed your attention also to paragraph 16 of the order, which shows the same figure for each of the yeas 1970 through 1973.

I also have directed your attention to paragraph 21 of the pre-trial order, which shows for each of the

years 1965 through 1973 the total dollar amount of brokerage commissions paid by Chemical Fund on the execution of its portfolio transactions.

I ask you to bear those numbers in mind in the questions I am about to ask you.

Are you familiar with the total number of Chemical Fund's shares outstanding at the beginning of each of the years 1965 through 1973?

A I am.

Q I am going to ask you to assume two facts, Mr. Maynard. You know what the word "recapture" means, I take it?

A Yes, sir.

Q I am going to ask you to assume that in each of the years 1965 through 1973 M & D recaptured all of the commissions paid by Chemical Fund on all portfolio transactions, and I am going to ask you to assume further that all of the commissions so recaptured were credited against the management fee paid or payable by Chemical Fund to M & D.

On those assumptions, I ask you this question, Mr. Maynard:

Would there have been any difference in the net asset value of a share of Chemical Fund on any day during

mph3 Maynard-direct

the years 1965 to 1973?

A No, there would not have been.

b2 Q Why not, sir?

A You earlier mentioned Rule 2(a)(4) as being the basis for determining current net asset value under the SEC requirements. A sub-paragraph of that rule permits that any expenses and/or income items except for dividends need not be accrued daily during the period when if cumulatively when netted those items do not equal as much as one penny a share.

The Chemical Fund has used that method of computing daily net asset value during this period, and we analyze the amount of sales and commissions of portfolio securities which were incurred during each of those 108 months in this nine-year period. As a result of that analysis and a comparison with the number of shares outstanding at the beginning of the year, which is the conservative approach, we determined that not once in those 108 months did the amount of total commissions amount to as much a half a cent a share even.

On that basis, following Rule 2(a)(4), it was not necessary for the Chemical Fund to take into consideration the amount that the change in the expenses which would have occurred had these commissions been 100 per cent

recaptured. Accordingly, in making that computation, there would have been no effect on the amount of management fee payable by Chemical Fund to F. Eberstadt M & D, and in answer to your question the net asset value computed on any one of the days in any of those 108 months would not have been affected.

MR. SCHWARTZ: Would your Honor like a copy of the Rule 284? I have it quoted in our papers.

I have no further questions.

THE COURT: How often did you do your calculations? Did you do a calculation twice a year, or have you done that calculation in connection with this litigation?

THE WITNESS: It is done in connection with each of those examinations at June 30th and December. We test other days during the year to see if their method of computation is consistent. As far as the calculation of the relationship of commissions--

THE COURT: That is what I am talking about.

THE WITNESS: I am sorry. It was done only in connection with this litigation.

THE COURT: Is that an exhibit? Has that been --

MR. SCHWARTZ: No. It is available if Mr. Schreiber wants to see it.

MR. SCHREIBER: I would like to see it. Do you have it?

CROSS EXAMINATION

BY MR. SCHREIBER:

Q Mr. Maynard, in answering Mr. Schwartz's last question, that is, ignoring or including this possibility of 100 per cent recapture would not have affected asset value by more than 1 cent a share, and therefore the directors quite properly could ignore this in determining net asset value per share, do you know whether or not the directors in fact considered that question?

A I do not know that, and I don't believe that's the way my answer read.

Q I heard your answer, Mr. Maynard, and your answer didn't read that way.

A I didn't say --

Q That is why I ask you. You do not know whether or not they considered including or excluding the recapturable potential?

A No; I don't know.

Q The rule pursuant to which net asset value is computed was 2(a)(4)?

A That's correct.

Q Subdivision 6, sub-subdivision (b) thereof--

MR. SCHREIBER: That appears, your Honor, at page 28 of defendants' pre-trial memorandum.

Q -- says, "The items which would otherwise be required to be reflected by subparagraphs 4 and 6 above need not be so reflected if cumulatively when netted they do not amount to as much as 1 cent per outstanding share."

That says, "need no". Had they included that, even though it didn't amount to as much as 1 cent per share, Mr. Maynard? Would that have been improper?

A No, sir.

Q It would have been proper also?

A Sure.

Q They had a choice to do it by including or by excluding; is that correct?

A I might say that they don't include the management fee either from the first of the month, and therefore the commissions would merely have been an offset to a management liability fee which otherwise would have accrued. If you did one I think you would have to do the other.

Q But they could have included or excluded the recapturable commissions, and either would have been correct, and you don't know whether they would have

considered it or decided in favor of one or the other, do you?

A Well, they didn't do it, so I assume they decided against it.

Q Do you know if they considered or adopted a resolution to do it that way or whether it was just done by some subordinate who acted on his own?

A I have no recollection that there was any-- that we ever considered whether this need be followed up.

Q Do you normally, in your audit, inspect the minutes of the board of directors' meetings of the fund?

A Yes.

Q Do you recall whether in any of the years that you referred to there was ever a minute in which there was included a resolution saying "include" or "exclude"?

A I have not attempted to refresh my recollection on that. I don't recollect either way.

Q Mr. Maynard, I show you what Mr. Schwartz has given me as the calculation upon which you predicate your one half cent or less than one half cent conclusion.

THE COURT: You had better mark it for identification if he is testifying from it.

MR. SCHREIBER: Very good, sir. I think that is an excellent suggestion.

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May we have that marked as a plaintiff's exhibit?

THE CLERK: Number 161.

MR. SCHREIBER: May I have it marked as Plaintiff's Exhibit 161 for identification.

(Plaintiff's Exhibit 161 marked for identification.)

xx 7

Q Is that the only calculation upon which you based your testimony about less than one-half of 1 cent?

A It's the only thing in writing. We use a calculator to come up with the conclusion. I didn't attempt to put down the arithmetical equation that we applied. The figures are all there.

b3

Q That is, the shares appear up on top?

A That's correct.

Q The commissions down below, and it is a matter of mental arithmetic to figure out--

A You can go through 108 of them, if you want to. It's easy enough to identify a half dozen that you want to check. If you want to look at June, 1967, I believe it is--it will save you the trouble.

Q If I understand this tabulation correctly, Mr. Maynard, let's start with 1973.

MR. SCHREIBER: May I approach the witness box, your Honor?

Q (Continuing) I believe this is the number of shares outstanding in 1973.

A Yes.

Q At the beginning, 77,141,000 shares?

A That's correct.

Q And the last figure in the column under 1973 represents what?

A It's the aggregate commissions paid during the year that shows in the pre-trial exhibit -- the pre-trial order.

Q And that figure, which also appears in paragraph XXI of the pre-trial order shows total commissions paid in '71 of $1,291,717.

A 735, I believe. I'm not sure. Some of these are rounded.

Q Well, your figure on 161 for identification is 1,291,717, but it really makes no difference.

Now, let's see if your one-half of 1 cent is correct. You will have to forgive me. I am sure that my ability at figures cannot match yours, Mr. Maynard, but taking the shares first, one cent a share on 77,000,000-odd shares -- that would be roughly $771,000?

A That's correct.

Q And the commission of $1,291,000 is a little more

than --

A That's for the year. I testified that there was not a single month in there in which there was as much as half a cent.

Q Oh, Mr. Maynard, I would never have understood that from your testimony.

A I thought I said that very clearly, sir.

Q Well, now, if you were computing asset value at the end of the year and you had a whole year's recapturable commissions to consider, might that have affected it by more than one-half of 1 cent?

A No, sir, because the commissions would be recorded on a monthly basis along with the management fee. The management fee greatly exceeds that $1,200,000.

Q Well, let's leave management fee apart for the moment, because in your testimony, Mr. Maynard, I think you were telling us that recapturable commission, assuming 100 per cent recapture, could not equal as much as one-half of 1 per cent, or one-half of 1 cent per share.

MR. SCHWARTZ: The question was, when offset against the management fee.

Q Mr. Maynard, did they charge the management fee in at any time during the year?

A On a monthly basis.

Q And on a monthly basis, when it is charged in, is that reflected on this sheet?

A No, sir.

Q So now we will talk about this sheet, Mr. Maynard.

On this sheet, at the end of a year, the total commissions would be more than a penny and a half a share, wouldn't they?

A Yes.

Q Now, let's try another year. Let's try the year 1972, for example, when the total shares outstanding were 33,637,000, and the total commissions were $939,000. That would be about three cents a share, wouldn't it?

A On the basis of outstandings at the beginning.

Q Now, let's try 1965, a give-up year. Total shares outstanding, 23,989,000, roughly 24,000,000. One cent a share would be 240,000. Total commissions that year were 339,000. That would be about a penny and a half a share, wouldn't it?

MR. SCHREIBER: No further questions, your Honor. I offer this Exhibit 161 in evidence.

THE CLERK: Any objection, Mr. Schwartz?

MR. SCHWARTZ: No objection.

(Plaintiff's Exhibit 161 for identification was received in evidence.)

THE COURT: Anything further, Mr. Schwartz?

MR. SCHWARTZ: No.

(Witness excused.)

MR. SCHWARTZ: Dr. Murray.

R O B E R T F. M U R R A Y, called as a witness by the defendants, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. SCHWARTZ:

Q Dr. Murray, are you a member of the board of directors of Chemical Fund?

A I am.

Q And for how many years have you been a director?

A Since 1959.

Q What is your present occupation?

A I am a professor of finance at the Graduate School of Business of Columbia University.

Q What subjects do you teach and what subjects have you taught in recent years?

A I teach pretty broadly through the finance area, but especially security analysis, capital markets and portfolio management.

Q Could you describe briefly for the court what

has been your academic and business experience?

A Well, I started as a trainee in June, 1932, in the banking business, and while I was working at Bankers Trust Company I completed my MBA and my Ph.D. at night in New York University in the Business School. In that institution I worked my way up the ladder, with the exception of some time in military service in World War II, and my responsibilities eventually became that of chief economist of the bank, the vice president in charge of the investment research function, and the final post I held there was in my role in charge of institutional investment management services of the bank.

I left Bankers Trust Company at the end of 1955 to become associate dean of the Graduate School of Business at Columbia, and then, in 1958, I was appointed a full-time professor of finance and became the first holder of the S. Sloane-Cole professorship in banking and finance.

I have been at Columbia since 1956, except for an interval of six years, during which I was a senior executive of the College Retirement Equities Fund. My final job there was as executive vice president of CREF, as it is known, and chairman of its finance committee. This meant that I was in effect the portfolio manager for this organization.

Q Would it breach any confidence if you stated on this record the approximate dollar value of the CREF portfolio which you managed?

A It was about $500,000,000 when I went there on a full-time basis, in 1965, and when I left it was about a billion and a half.

I had served as a trustee of CREF prior to going there full time, and I completed my term there in 1972 as a trustee.

Q When you were portfolio manager at CRED, did you have any responsibility for the execution of portfolio transactions?

A Yes. That was under my direct supervision.

Q At Bankers Trust would it breach any confidence if I asked you or if you answered in general terms the dollar value of the portfolios for which you had responsibility?

A When I was in the personal trust area it ran, as I remember, between a hundred and two hundred million. When I got in the institutional work in the latter part of my assignment there the volume was running about five or six hundred million.

Q Did you have any responsibility at Bankers Trust Company for the execution of portfolio transactions?

A We had our own trading department, but I was responsible for directing them in the execution of the individual orders for the portfolios under my supervision.

Q Are you a director or trustee of organizations other than Chemical Fund?

A Yes, I am a director of the Survey Fund and some other mutual funds, a couple of insurance companies, the New York Bank For Savings, and a number or organizations in the non-profit world, like our Common Fund for Non-Profit organizations, the Investors Responsibility Research Center, Catalyst; I serve as a trustee and chairman of the investment committee of Smith College, and currently I am serving as a trustee of Andover.

Q Have you also served as chairman of the White House Committee on Aging?

A Yes, I served as chairman of one of the divisions there as a follow-on from my service on the President's Task Force on Aging.

Q Have you been a member of the Economic Study Committee of the Investment Committee Institute?

A Yes, I have served on that since it was organized.

Q Are you aware of the Governor's Council, that is, the Governor of the State of New York's Council on Economic Advisers?

A Yes, I have been serving in that capacity.

Q Did you mention the Investor Responsibility Research Center?

A I have, yes.

Q Have you written in the field of portfolio management?

A Yes, I have written a good many articles, and especially on those aspects involving pension funds. But I also wrote the chapter in a book on financial institutions on markets that dealt with the investment company industry.

Q Turning to your post as director of Chemical Fund, have you served since 1959 on any committees of the

board of directors?

A Yes, I have served on the portfolio committee from time to time; I have also served on the committee of independent directors to review the management and distribution contract of the Chemical Fund; I guess I served one year on the Audit Committee of the Fund.

Q Let me ask you a few questions, sit, about the subcommittee of independent directors which reviews renewal of the management contract.

How often in the years '65 through '73 was such a committee constituted?

A I think it was every year, beginning along about—well, we met every year and I guess we wrote a formal report every year beginning in about 1967, as I recall.

Q In those formal reports which you wrote in the years '67 to date, was there mention of the possibility of recapture and the Fund's policy with regard to brokerage commissions?

A One of the items always on our agenda was the consideration of that question.

Q Dr. Murray, what is Chemical Fund's brokerage policy?

A The basic policy is determined by the board of directors, specifically, by the independent directors.

That policy as it has been stated repeatedly over the years has been to delegate to the manager the specific allocation of commission business within guidelines established by the board of directors.

Q What are those guidelines?

A Those guidelines are that the manager shall at all times seek best execution for the purchase or sale transaction. Subject to that overriding consideration prior to mid-1973 the manager was encouraged to use commission business as a means of stimulating sales of Fund shares.

In addition, throughout the entire period, including the period before and after last year, the manager has been encouraged to use brokerage commission business to secure statistical and other services and to obtain investment information, investment research recommendations from the broker-dealer community.

Since mid-1973 it has not been possible, I regret to say, to use brokerage commission directly for sales. Sales may not be considered as a qualifying or disqualifying factor in the allocation of business.

MR. SCHREIBER: Your Honor, I note that the witness has before him some pages and writings. May I ask what those are?

THE WITNESS: These are my personal notes; this is my biographical sketch; and these are notes that I made to help me remember selected dates.

MR. SCHREIBER: Thank you.

MR. SCHWARTZ: Will that be the last interruption, Mr. Schreiber?

MR. SCHREIBER: I can't promise. I will do my best.

Q Have you finished your answer?

A Yes.

Q Is there a Chemical Fund policy with respect to the use of Eberstadt & Company for the execution of Fund portfolio transactions?

A There has always been -- I say always -- in my entire experience with the Fund the policy has been not to use F. Eberstadt & Company. In more recent years the independent directors have specifically reinforced that general policy statement by a specific prohibition against their using F. Eberstadt & Company without the specific approval of the independent directors.

Q Who was it that determined that Eberstadt would not be used as a broker?

A It was determined long ago by Fred Eberstadt himself. When the Eberstadt firm became a member firm

it was natural that this question would arise. Mr. Eberstadt himself told us as directors of the Fund that it was not his intention, nor did he think it was desirable, that transactions be place with F. Eberstadt & Company now that they were a Stock Exchange member, and we as individual directors, and, particularly, independent directors, were in complete agreement with that policy, which became continuously operative from that time onward.

Q For how long have you been aware, Dr. Murray, that there were means by which brokerage commissions could be recaptured and credited against an investment advisory fee?

THE COURT: May I interrupt before you ask the question?

Can you, Dr. Murray, give me some time? You said there was a policy? Has it been the policy since '59? Since you were on the board?

THE WITNESS: Yes, but I understood it was the policy prior to that time.

THE COURT: You were aware of the policy since 1959?

THE WITNESS: Indeed, I was aware of the policy when I discussed the question of becoming a director, because I did not want to be a director of a fund where

that was not the policy.

THE COURT: When was that?

THE WITNESS: That was in late 1958, when I was being discussed as a potential director for the following spring.

THE COURT: I guess you will have to reask the question.

Q You have heard the word "recapture," Dr. Murray?

A Yes.

Q What does it mean to you?

A It means recovering or retrieving or getting a rebate of a portion of a fee, a service charge that someone has paid for the performing of a service or a transaction.

In this particular context of the brokerage business it would be a question of getting back in some form or another a portion of a commission paid to a broker on a security transaction.

Q Are you aware that there are devices by which it is apparently possible for an investment adviser to by executing portfolio transactions to credit commissions against the management fee charged?

A Yes.

Q For how long have you been aware of that?

A It would go back to the practices of mutual

funds that had been in operation for at least 30 years, perhaps longer.

Q Are you aware of recaptured devices which don't utilize a New York Stock Exchange seat?

A Yes.

Q Are you aware of recaptured devices which depend on membership in the NASD?

A Yes, I am.

Q For how long have you been aware of these?

A The device of membership on one of the regional exchanges, it seems to me, has developed much more recently. In fact, it was not widespread at all in my awareness or consciousness prior to the time that give-ups were abolished. I am sure it was used prior to that time, but what gave it an impetus was the abolition in December, 1968, of the give-up, and it was at that time that a good many people tried to search out devices and schemes and subterfuges for trying to get around the rules against commission rebates, a rule which the New York Stock Exchange has tried over the years to enforce, but it has been a target for a wide variety of evasions.

Q Have these various methods of recapture of brokerage commissions been the subject of discussion within the Chemical Fund board?

A Yes.

Q On how many occasions or on what occasions were these discussions had in the years '65 through '73?

A I don't believe I could accurately estimate the number of occasions, but, obviously, they were discussed annually at the time when we discussed renewal of the management and distribution contract, and then in between, as whenever we read or heard about or talked about some of the changes in or suggested changes in the regulatory environment or in legal decisions. So that there must have been three or four or more other times a year in which these questions would be formally discussed at board meetings or at portfolio committee meetings or at the luncheon table.

Q Do you recall a Securities and Exchange Commission report issued at the end of 1966 which is sometimes shorthandedly reported as the PPI or Public Policy Implementation report?

A Yes.

Q Did you read that report?

A Yes, I did.

Q Did you note when you read it the views expressed therein by the recapture of commissions by investment companies?

A Yes.

Q Were those views as expressed in the report discussed by the board of Chemical Fund?

A Yes, they were actively discussed.

Q Do you recall in January, 1968, a proposed rule promulgated by the SEC, Rule 10(b)(10)?

A Yes.

Q Do you have any present recollection of the substance of that proposed rule?

A That rule, as I recall, was designed to work almost as a requirement that funds seek commission rebates by any presumably legitimate device available?

Q Was it the subject of that rule discussed within the Fund's board of directors?

A Yes.

Q Did the directors consult counsel?

A Yes, they did.

Q Did the directors receive a written opinion of counsel?

A Yes. The directors were of one mind, that they did not wish to follow the proposals made in that SEC release, and so they sought confirmation from counsel of the propriety of reaching that determination.

Q Did you as a director of Chemical Fund rely on

the opinion which you received from counsel?

A I certainly did.

Q Do you recall that after the proposed Rule 10(b)(10) there was another SEC release in 1969 on the subject of recapture, No. 8746?

A Yes. I don't remember the number, but I remember the event.

Q Let me show you a copy of Exhibit O, Dr. Murray, which is a copy of the SEC release 8746, and ask you if you were familiar with it at or about the time it was published?

A Yes, I was, I should say, familiar with this. In fact, it caused some entertainment, if one can obtain entertainment from this long discussion.

Q In what sense did it provide entertainment, if I may use your word?

A It seemed to many of us like a very elaborate method of withdrawing a position or so substantially weakening a position as to amount to a withdrawal and then trying to rationalize that whole process of withdrawal by some lot of verbiage.

Q What was your understanding after reading that release of the SEC's position on the duty of the Fund to recapture?

A My understanding was they had retreated completely from taking that position.

Q Did you ever read the decision of the First Circuit Court of Appeals in Moses versus Bergen?

A Yes.

Q Where did you get the copy which you read?

A That was provided to me by the Fund.

Q Do you know whether copies of that opinion were distributed to all of the directors of the Fund?

A I believe they were.

Q Was there a discussion of that opinion among the directors of the Fund?

A There was a discussion among the directors individually and at our board meetings.

Q Did the directors consult counsel?

A Counsel was consulted to determine whether the previous opinion of counsel still stood as counsel's advice to directors.

Q What were these directors told by counsel in answer to that question?

A They were told that there was no change in the substance of the previous opinion.

Q Just so the record is clear, Dr. Murray, let me show you a copy of Plaintiff's Exhibit 75 and ask you if

that is the opinion of counsel which you have referred to?

A That is the one dated February 20, 1968.

Q Did you as a director of Chemical Fund have an opinion during the years 1965 to 1973 on whether or not Eberstadt should be used as broker for the Fund and whether or not if it was used as broker for the Fund its brokerage function should be the occasion for the recapture of commissions?

A I did.

Q What conclusion did you reach?

A I was unalterably opposed to engaging in that pratice.

Q Could you tell us please, Dr. Murray, the reasons for that conclusion in your own words, in your own order, and you are free to refer to your notes at any time?

A To mere there were a combination of reasons, and although I can list them individually, I think they are all part of a single conviction on my part.

One of the problems in placing the orders with F. Eberstadt & Company was that it opened up the possibility of a conflict of interest situation. When the trader on the desk of that firm received a purchase or sale order from Chemical Fund and simulatenously from

another client of the firm, from the institutional services division of the firm, he would be left in the position of trying to decide whether to give priority to Chemical Fund or to one of the other clients to whom the firm had a responsibility.

I have the utmost convidence in the integrity of everybody in the Eberstadt organization, but I cannot see how they can resolve these kinds of conflicts, of priorities with consistency no matter how well guided are their motives.

It seems to me preferable at all times that the person negotiating the transaction for Chemical Fund be acting solely on behalf of Chemical Fund with that undivided loyalty to the Fund and to no one else.

Also, I would like to be able to hold the individual acting on behalf of the Fund directly responsible.

When John Van Derventer executes an order for Chemical Fund, I am going to see him at the board meeting or at our portfolio committee meeting, and I can ask him how did he handle that transaction, and he knows that when he handles it he has to face me and the other directors.

In a period of negotiated commissions, such as we have had in the last two years and more, there would

be a problem in negotiating commissions with F. Eberstadt & Company, the parent of M. & D.

How could one unravel the different factors at work in that negotiating process? Surely, you could not call upon the independent directors to negotiate each transaction in order to assure arm's length bargaining in that process.

Besides, it is unfortunate to have orders for Chemical Fund coming on the floor of the New York Stock Exchange with a floor trader or a broker employed by F. Eberstadt & Company because this can lead other floor brokers to perceive who is the major factor involved in the transaction on the floor. It's very advantageous if you are trying to liquidate a large block of stock in an orderly manner over a span of time to be able to use one, two, five or a dozen different brokers, so that there is not a concentration of buying or selling interest shown by a single firm.

Another reason in my mind that is powerfully important is the fact that if the business were given exclusively or predominantly to F. Eberstadt & Company, other broker-dealers would have no incentives to seek out the opportunity to perform services for Chemical Fund, to provide it with investment information, to provide it with

statistical and other kinds of services that would be of assistance in the management of the portfolio.

Prior to the Middle of last year if no broker had an opportunity to obtain commission business as a result of being an effective distributor of Chemical Fund shares, it is clear to me that the broker-dealer community would not have been willing or anxious to sell Chemical Fund shares in competition with other funds that were rewarding them generously with give-ups or with direct commission business.

It seems to me vitally important that the Fund have the benefit of a continuing flow of new sales of shares in order to enhance the opportunities for good performance.

And while I do not want to take anything from anyone in the last few years for the outstanding performance of Chemical Fund, it is clear to me that one of the reasons why the shareholders of Chemical Fund have had one ofthe very best investment experiences in the entire industry is because unlike the rest of the industry, Chemical Fund has had a positive cash flow resulting from sales in excess of the redemption ofthe existing shares. So this is vitally important to the efficiency and effectiveness and the quality of performance of the Fund.

There is also one overriding consideration in my mind that has always weighed very heavily, and that the Chemical Fund has benefited in its experience because of its continuing positive cash flow and from its standing and reputation as being widely known everywhere you turn as a fund which has always been managed in the highest standards of integrity and fair dealing.

Now, if the commission business were put through F. Eberstadt & Company there would always be in the minds of investors or potential investors or the public to which the shares were offered the suspicion, no matter how unwarranted, that now there would be an increase In turnover, that there would be churning of the portfolio in order to generate an enlarged volume of commission business.

There would always be a question about the size of the give-up, the terms on which rebates were given to the Fund by the affiliated broker-dealer. I have felt ever since I have been a director of Chemical Fund that one of my responsibilities to our present and potential stockholders that I would do everything within my power to retain that reputation for integrity, responsibility and accountability that the Fund has enjoyed for some 35 years and longer.

Now, in addition to those reasons which I have stated in, I hope, fairly specific terms, there was, of course. always the overriding consideration that the commission structure was not there to stay. It was evident to any thoughtful observer that the excessive level of fixed rate commissions could not persist indefinitely. This conviction was, of course, reinforced by a continuing barrage of questions and criticisms and exceptions, and then finally beginning in 1972 we had negotiated commissions established on transactions in excess of $500,000.

T4 A year later or so, commissions were made negotiable for transactions in excess of $300,000, and it was evident to me all through this period that the excessive commissions, the fat, if you will, in the commission scale was going to be eliminated by going to negotiated rates, or some other technique would be devised, and under these circumstances, it would be an especially foolish step for the directors of Chemical Fund to take to impair the effectiveness of the ongoing organization for what was obviously going to be an extremely short-lived and temporary, minor dollar saving to the fund, a dollar saving which in no way could be found commensurate with the disadvantage associated with bringing the affiliated broker-dealer into the net worth of decisions and transactions affecting the fund's portfolio.

Q Dr. Murray, did the so-called Martin report have any bearing in your consideration of the fund's brokerage policy?

A It did, indeed, because this was, again, one of the documents -- another one of the discussions that was constantly reminding a thoughtful observer of the scene that the fixed commission, the days of the fixed commission and its complicated structure of rebates was not long for this world.

Q You testified, Dr. Murray, to to the need or the benefits of positive cash flow for effective portfolio management. Could you explain that, please? Why is cash flow important for effective portfolio management?

A When you are sitting there trying to plan a portfolio and make individual investment selections for the fund, you cannot be sure at any point in time whether the expected result is going to be realized in a short time or over an extended period of time. Particularly in funds like Chemical Fund, with its emphasis on long term investment results. you need to have time on your side to be able to have confidence that a good investment decision is going to be advantageous and fruitful and contribute to the performance of the fund.

If you are exposed to an uncertain outflow of funds, you are in no position to take that kind of a risk. Suppose after careful analysis you have uncovered an attractive investment opportunity, but you cannot tell in the typical case whether this is going to work out in six months or in six years. If you are going to be able to go ahead with that decision with confidence, you must be entitled to feel that you can make that investment and you can follow it through over a span of time, and you are not going to be called upon to liquidate it at a timing

of someone else's choosing simply because you have to meet redemptions.

b2 On the contrary, if you have an assured cash flow, you can go out there and look for the opportunities. You know that if you buy some of the shares of the company now and you are a little bit premature, you will have a chance to come again and buy some more, and so you will be able to build a position in a company over a span of time, and you can do this deliberately, and you can do it at times of your own choosing.

But this is only true if you can go ahead with confidence, with the assurance that you are going to have a positive cash flow into the fund.

Q Do continued sales of the fund have any impact on costs per dollar under management?

A The tapered management fee declines with the sales of the fund, and so there is a saving on the management fee to existing shareholders if the fund continues to grow.

Q In your opinion, is there a relationship between the sales of the fund's shares and its investment performance?

A Yes; there is. The sales will be stimulatd across time by good performance.

Q And what effect do the sales themselves have on performance, if any?

A The sales themselves, by producing that positive cash flow, make a very important contribution to the investment decision making process and therefore to the performance of the fund.

MR. SCHWARTZ: I have no further questions.

THE COURT: Mr. Schreiber?

CROSS EXAMINATION

BY MR. SCHREIBER:

Q I have a few questions I would like to ask you, Dr. Murray.

Dr. Murray, your principal occupation is as professor at Columbia University?

A Yes; it is.

Q And you have all of these other interests as well?

A I did have other interests that are compatible with my teaching responsibilities.

Q -- which you have enumerated?

A Yes.

Q What is your compensation at Chemical Fund?

A I receive a fee, as I recall -- it is now $5,000 a year, plus, I think it is $200 for every board meeting I attend.

Q Was that increased since September of this year?

A No. In my deposition in September of this year I quoted the old fee prior to the increase.

Q So that when you said in September of this year that your fee was $3,000 a year, you were in error?

A I was just plain wrong.

Q Now, what proportion of your time do you devote to this Chemical Fund?

A I would suppose that I spend about the equivalent of about two days a month.

Q To Chemical Fund?

A Yes.

Q How many days a month do you teach at the university, professor?

A I teach normally on three different -- three different days.

Q Three days a week?

A A week, yes.

Q And you also are affiliated with Surveyor Fund?

A Yes, sir.

Q How many days a month do you give them?

A I would suppose I give them roughly the same, although probably a little bit more, because there I am serving as chairman of the portfolio committee.

Q And your time, of course, is occupied with the

other activities you have mentioned as well; is that correct?

A Yes, sir.

Q By no means would you call your occupation or preoccupation with Chemical Fund a full-time occupation, professor?

A Certainly not.

Q Now, you have enumerated some reasons why Eberstadt should not be used as the execution broker for the sale of portfolio securities for the fund. I would like to direct your attention back in time, to 1965 through December 5th of 1968, when give-ups were possible, and in each of these reasons which you have given why Eberstadt should not be the executing broker, I want to see if they apply with equal force to this situation, that is, a situation where Eberstadt is just the recipient of give-ups, not doing any actual execution, not participating in any way in the actual execution of the transaction, doing nothing more than the other recipients of give-ups did, except that it might be availabile for recapture through diminution of the advisory fee paid Eberstadt's subsidiary, M & D.

Now, the first reason you gave why Eberstadt should not be an executing broker for fund shares was the

possibility of conflict of interest, and correct me, professor, if I misstate your testimony, but you said that conflict of interest might arise if at the trading desk an order came in from Eberstadt to sell and an order simultaneously arrived from one of its other customers to sell, who gets priority?

Am I phrasing your objection correctly?

A That is correct.

Q Would that apply if we are talking only of give-ups?

A It would be a different conflict of interest on give-ups.

Q We will get to that, if you will, in a moment.

Would this kind of conflict of interest apply?

A The conflict of interest applies in the-- or at the execution of the order. The conflict of interest is not in this case on the trading basis. It is on the negotiation of the level of the give-up.

Q Professor, forgive me. We are talking about the conflict of interest about which you spoke, the conflict of interest at the trading desk. Which customer's order gets priority?

Would that apply in the situation of a give-up?

A Not that, but the other one would apply.

Q We will get to the other one, professor. Just--

A No. Your question will not lead to the other one, because you are taking it item by item.

MR. SCHREIBER: Your Honor, I must be forgiven if I ask that the witness answer my question, and if he wants to answer another question, let his counsel put it.

THE COURT: Will you answer the question posed, Dr. Murray, and if you need an explanation, you will be permitted to give it.

Q Now, professor, getting back to my question, would the conflict of interest at the trading desk, as to whose order gets priority, apply if Eberstadt is only a give-up recipient and not an executing broker?

A The conflict over priority of order execution would not be involved in the give-up instance.

Q Now, professor, let me ask you another one. We will digress a moment from your various reasons.

By not using Eberstadt as an executing broker in this period from 1965 to 1968, and, for that matter, right on down to date, when the fund gives an order to an executing broker, do you know whether that executing broker's only customer is the fund, or does it have other customers?

A It has other customers.

b3 Q And how do you assure yourself that those other customers are not simultaneously placing like orders competitive with those placed by the fund at the same time?

A I do not have to do business with any of those brokers, and if they give me second standing in their execution performance, I simply do not do business with them.

Q Of course --

A So I have that discipline over the choice of how they serve their multiplicity of customers.

Q And you couldn't have that choice with Eberstadt?

A Not if I had determined that all transactions were to go to Eberstadt, because Eberstadt couldn't, in all conscience, give Chemical Fund always first priority.

Q And I assume the actual executing broker who has been doing the execution all these years for Eberstadt couldn't give Eberstadt absolute priority at all times, either, because it had other customers?

A It could make no guarantee, but there would always be the arm's length bargaining, with one broker or against another broker.

Q And did you personally have anything to do with supervising those actual executing brokers to see whether they had other competing customers?

A You mean in the Chemical Fund case or in my own activities?

Q No. Where the Chemical Fund is selling through brokers other than Eberstadt all these years, did you assure yourself personally that they didn't have other customers placing competitive orders?

A The independent directors do not take up residence in the order room, so of course I did not.

Q You left that to M & D, didn't you?

A That's their responsibility.

Q Now, let's get back to the other reasons why you said you couldn't use Eberstadt as a give-up recipient for recapture purposes.

After the conflict of interest at the trading desk, which you now say wouldn't apply, the next one was direct responsibility. Do you remember saying that?

A Yes.

Q That is, by not having Eberstadt as executing broker, you could have direct responsibility?

A With the officer of the fund in M & D who was handling the transaction himself for the Chemical Fund?

Q That's right.

A Yes, sir.

Q Would that same objection apply if Eberstadt was

to be used only as a give-up recipient?

A Not as to the transaction but only as to the terms of the give-up.

Q Well, now, let's do things one at a time, professor.

I am talking about as to the transaction. Would you still have the objection about lack of direct responsibility?

A I said that as far as the transaction was concerned, it was not involved.

Q So that that objection would not apply to give-up receipt; is that right?

A The priority of transaction objection would not.

Q And how about the direct responsibility objection?

A The direct responsibility would still be retained.

Q That would still be an objection to give-ups?

A No. The direct responsibility of the officer of CREF to me as an independent director would not be impaired by his executing orders through another broker but directing give-ups to Eberstadt and Company.

Q Well, forgive me if I have to ask this again, because I am not at all sure I understood your answer.

You had an objection to using Eberstadt for direct execution, that objection being the breakdown in

direct responsibility; is that right?

A That's correct.

Q And I ask you now, would that same objection apply if Eberstadt was used only for receipt of give-ups?

A And my answer was no.

Q Thank you. Now, your next objection to the use of Eberstadt for direct execution had to do with negotiated commissions. That didn't occur until 1972, did it? You didn't start negotiated commissions until '72?

A May I restate what my testimony -- what I actually said?

Q Yes.

A What I actually said was that all through this period it was expected by me and by many other observers that negotiated commissions would come and in fact they came in stages beginning in 1972. I did not say--

MR. SCHWARTZ: 1971, as a matter of fact.

Q We will correct you, professor. It was '71, but go ahead. It doesn't make any difference.

A The point I was making was simply that it was clear to all of us that fixed commissions were not long for this world, and that expectation was borne out by subsequent events.

Q However, even with that seer-like forecast of what would take place in 1971 or thereafter, that would not have applied to recapture of give-ups in the 1965-to-1968 period, would it?

THE COURT: Mr. Schreiber, I would appreciate it if in your questioning you would rely on the question rather than comments.

MR. SCHREIBER: If I make any comments, it is purely inadvertent, and I will try to avoid it. Thank you, your Honor.

Q Now, professor, the negotiated commissions did not start until 1971, so that that could not have affected the use of Eberstadt as a recipient of recapture in the period which terminated December 5, 1968, could it?

A It could not -- it did not impair the availability of give-ups. Obviously, as long as the fixed commissions were there and give-ups were permitted, there was always an alternative use of give-ups.

Q But there was no difficulty in negotiation, because there was no negotiation of rates until after December 5th of 1968?

A There was a negotiation of the size of give-ups.

Q I understand, sir, but--

A That isn't the negotiating to which I referred.

Not to negotiation of commissions.

Q Well, when you talked about the difficulty of using Eberstadt as a negotiating broker -- rather, as an execution broker, you were speaking of negotiating commission rates, were you not?

b4

A Negotiating rebates. Negotiating give-ups.

Q Well, now, let's try one at a time, if I may.

In response to Mr. Schwartz's questioning as to why you couldn't use Eberstadt as an execution broker, the negotiation that you were talking about, which would be difficult between the fund and its parent, Eberstadt, its sponsor, Eberstadt, was a negotiation of the amount of commissions, was it not?

A At that particular point I was referring to the negotiated commissions that came into operation after '71, at thatparticular point in my testimony.

Q And my questioning now is directed to the pre-December 5, 1968, period, when there were no negotiated commissions.

A There were negotiated rebates.

Q But no negotiated commissions.

A There were not negotiated commissions.

Q So there would be no difficulty in negotiating commissions, because you couldn't negotiate commissions

until 1971.

A The only difficulty would arise in negotiating the size of the rebate.

Q Right.

A And that to me is a serious problem.

Q Very good. But now if you negotiated the amount of the give-up with the broker who actually executed, he is unrelated to Eberstadt and he is unrelated to the fund, and you had to negotiate that with him, anyway, didn't you?

A Yes.

Q Fine.

A You had to negotiate that with him.

Q Now, having negotiated the amount or percentage of the give-up with the actual executing broker, there would be no difficulty negotiating anything with Eberstadt, because whatever that broker was going to give up would come to Eberstadt; is that not right?

A That is-- whatever Eberstadt got as -- as a firm would be the result of the negotiation that had taken place with the executing broker.

Q And that negotiation you had to have, anyway, as long as you had to have give-ups, no matter whom you sent them to; is that correct?

A That's correct.

Q By the way, you are familiar with the scale of those give-ups, aren't you, the percentage, roughly?

A When the subsequent hearings came out, I found out that I was not as familiar as I thought I was, because some firms got -- gave give-ups much larger than I had been able to negotiate, myself.

Q Some of them gave up substantially more than 50 per cent?

A That's right.

Q Some of them gave up 70 per cent?

A They did, indeed.

Q Some of them gave up more?

A I don't know any offhand that gave up more than 70 per cent.

Q Now, coming back to the objections you found that would prevent using Eberstadt as an executing broker, when Mr. Schwartz was questioning you, number 4 was in fact that if the fund used Eberstadt for all of its executions, people in the street would say, "Any Eberstadt transaction is probably for the fund," and it would show the hand of the fund; is that right?

A That is not my testimony.

Q Well, then, you correct me, sir, because I don't

want to misstate your testimony.

A All right. Let me restate what I said. What I said was, it was a positive advantage, if you were trying to move large blocks of stock either on the buy or sell side, if you had the flexibility of using a number of brokers and different brokers at different points in time, so that there was not a concentrated flow of orders through any broker, Eberstadt or anybody else, and it would be particularly disadvantageous because of the potential tie, of course, of Eberstadt, if Eberstadt were dealing for Chemical Fund, to have that kind of disability on the floor.

Q Thank you, professor.

Now, my question to you is, would that same objection apply if some other broker were the executing broker and all Eberstadt did is receive the give-up? Would that still tip the hand?

A Not necessarily.

Q Thank you. Now, your next objection to using Eberstadt as the executing broker was that if the business were given exclusively to Eberstadt there would be no incentive to perform services for the fund, and I emphasize the words "for the fund", and the services you mentioned were investment information, which is another label for

research; isn't it?

A Yes.

Q And statistical service?

A Yes.

Q And prior to mid-1973, sales?

A Sales.

Q Now, start with it in reverse order. Were the statistical services rendered to M & D or to the fund?

A It's not really in any meaningful way to separate the two. As long as M & D is managing the fund and the officers of the fund are officers of M & D, there is really no distinction between the fund and M & D. If M & D benefits, the fund benefits. If the fund benefits, M & D may be in some sense benefited.

Q Does the same apply to investment research?

A Yes. The quality of performance presumably benefits -- well, in this case it benefits the fund, because M & D is not a collection of assets. It's a service entity.

Q So that by having these brokers perform this research and statistical service for M & D, they were in effect helping the fund?

A That is correct.

Q And wasn't M & D under contract itself to supply

statistical and research information to the fund in return for the millions of dollars set forth in the pre-trial order as its advisory fee?

A It had responsibility to provide those services but none of us as independent directors ever have been persuaded that M & D is the custodian of all abilities and all wisdom. Therefore, we have always been most anxious to have the thinking of M & D ventilated and exposed to other kinds of judgments and expertise available in Wall Street.

Q But you were paying M & D for that research and statistical service, weren't you?

A The amount we were paying them was for what they could do, and they could not be an expert in all fields, and if they didn't have the benefit of those give-ups or commission business to use for getting outside additional facilities, we would have had to raise their fee and make a -- arrange for them to buy them, because we were convinced it was essential to the performance of the fund that that kind of exposure to other ideas got into the decision making process of the fund.

Q Now, professor, you said you would have had to raise their fee. That fee is provided for in the management or advisory contract, isn't it?

mph20 Murray-cross

A That's right.

Q And at a point it was set forth as a percentage of net assets, and thereafter a percentage of net assets plus some incentive, wasn't it?

b5 A Yes.

Q Whichever way it was, was there anything in any of those contracts from Genesis down to date that said, "In addition to the amount that we are going to pay you pursuant to this contract, more than a million dollars each and every year, you may use a percentage of commissions on portfolio transactions as you will to compensate people who will help you provide these research and statistical services for us for which we are paying you, M & D"?

A It was fully understood that that would be done.

Q Is there anything in writing that reflects that "fully understood", Doctor?

A There was no need to put it in writing. It was explicit and clear in the prospectus and in the proxy statements that the brokerage commissions were being allocated for investment information.

Q Was it ever clear in the prospectus, in the proxy statements or in any other communication to the shareholders of the fund that give-ups were being directed prior to December 5, 1968, to brokers who did not participate

in the execution?

A I don't believe that the form of compensation was reported, because that was a matter of form and not of substance. It doesn't make any difference whether you paid them with commission dollars or with give-ups. It wouldn't make a particle of difference. There was no reason to make a production of it.

Q The answer, professor, is that it wasn't indicated that give-ups were being given to people who did not participate in the execution?

A As far as I know, that particular item was not specifically reported.

Q Now, let's see if we can get back to another of the reasons that you gave, which was that the fund was widely known for integrity and fair dealing, and the public would expect churning to enlarge commissions if executions were given to Eberstadt.

Would that be true also if instead of allocating executions Eberstadt was just to receive and credit 100 per cent of give-ups? Would they still suspect churning?

A The people would, basically. People are very suspicious of these kinds of relationships. They don't understand what give-ups are. They would feel that, I am absolutely certain, they would feel that something was

going on here that didn't quite meet the eye and that this elaborate business of rebating commissions was some kind of device through which somebody was going to take a little bit of cream.

Q That is, it could not be explained to the shareholders or the public that the give-up would be credited 100 per cent against the advisory fee, that nothing was sticking in the pocket of Eberstadt, and the whole benefit was going to the fund?

A The public had never received give-ups. They did not understand what give-ups are. Give-ups are a nasty word in most of their minds. And it would be extraordinarily difficult, if not impossible, to take them through the step by step process by which this was accomplished.

Q It could not --

A Under those circumstances it would clearly, in my judgment, impair the credibility of the fund to try to get into the detailed elaboration of this kind of an arrangement to people to whom it was totally incomprehensible and totally foreign to their experience.

Q That is, the shareholders would never understand that the give-ups were being arranged for their benefit and that they were not being cheated?

A They would have grave difficulty in believing

that there wasn't something going on here that did not meet the eye.

Q But the shareholders could understand the statement in the prospectuses about allocations for sales and allocation for services? That was relatively simple, wasn't it?

A Not really very simple or clear to them, but was one of the things that was required that you try to make an estimate of. So it was an effort. I am sure not many of them could understand what this was all about.

Q And the last item you mentioned that would inhibit allocation of execution commissions to Eberstadt was the fact that fixed rates were not there to stay and, in fact, negotiated rates started in 1971. We have already covered that. And though you mentioned it last in order, I guess we anticipated it in your earlier answers. So much for give-ups.

Now I have a few other questions, Professor.

You testified that you and your other directors, including the outside unaffiliated independent directors received a copy of the opinion of Judge Bailey Aldrich in Moses versus Bergen?

A That is correct.

Q And you read it?

A Yes, sir.

Q And you read that part that said that if recapture is freely available to the Fund the directors have no choice but to recapture?

A I read that statement, yes.

Q Having read it what did you do about it?

A We had that discussion when we dealt with the question of whether that conclusion was applicable to the circumstances of Chemical Fund. We satisfied ourselves that it was not applicable and we affirmed our position.

Q Well, that decision was June 4, 1971, by which time give-ups were no longer possible, were they?

A That is correct.

Q So you directed your attention solely to the possibility of other methods of recapture, methods other than sending give-ups to Eberstadt and credited?

A Yes.

Q It was no longer feasible to consider give-ups?

A That is correct.

Q Did you give any consideration to whether or not the Fund should assert a claim against M. & D. or Eberstadt for the failure to recapture during the pre-December 5, 1968 period?

MR. SCHWARTZ: I object to that. I can see no possible relevance to this case.

THE COURT: Whether they considered it or not?

MR. SCHREIBER: I will withdraw the question.

THE COURT: Whether they considered it or not, they didn't do it.

MR. SCHREIBER: The fact is they didn't do it. I am content with that.

Q Your attention was focused On other methods of recapture? Did you consider the method of preferred rate non-membership on regional exchanges?

A Yes.

Q Did you consider recapture through directing executing commissions to Eberstadt?

A Yes.

Q Qnd you adhered to the prior practice?

A Yes.

Q For the reasons that you enumerated?

A Yes.

MR. SCHREIBER: May I just have a moment to consult my notes, your Honor.

Q Professor, you said that if brokerage executions were allocated to Eberstadt there would be a suspicion of churning or overtrading portfolio securities to generate larger commissions? Is that correct?

A That is correct.

Q Did that same fear of being suspected of churning arise because M. & D. was using either allocation of commissions or give-ups to motivate sales or research services rendered to M. & D.?

Is my question not clear?

A It is not clear. Let me either have it back again --

Q Let me try it again.

M. & D. was using give-ups during the give-up period to provide additional incentive to brokers who sold Fund shares? Is that not correct?

A That is correct.

Q And to provide additional incentive to brokers who gave research services to M. & D.?

A That is correct.

Q Now, the more portfolio transactions there were in this '65-'68 period, the more give-ups there could be and more dollars directed to people who sold Fund shares or provided research to M. & D.? Is that not correct?

A Yes. Now I see your question.

Q Now my question is, since that would have provided more dollars, that is, greater transactions would have provided more dollars, was it ever suspected that M. & D. was churning the portfolio of the Fund to

provide more dollars through give-ups?

A No, it was not.

Q But if Eberstadt had been the commission broker it would have been suspected of that?

A Yes, indeed it would have.

Q Would your answer be the same, sir, if Eberstadt were the executing broker and agreed to turn over a proportion of its profits as a credit against the advisory fee?

A My answer would be the same.

Q After Judge Aldrich's decision in Moses against Bergen in 1971, you, Governor Driscoll and Mr. Fox were appointed a subcommittee to review allocations in the light of Moses versus Bergen?

A Yes.

Q What did you do in connection with that review?

A We got together before or after board meetings to discuss the issues that had been raised and to obtain additional pieces of information from the manager.

Q That was Mr. Porter?

A Mr. Porter, yes.

Q You asked Mr. Porter to get some additional information?

A Yes.

Q Did you get any additional information independently on your own or did you do it all through Mr. Porter?

A No, because I was regularly involved in these questions in many ways and with my faculty colleagues I had additional sources of information of my own.

Q That is, your talked with some ofyour close friends, I believe, as you testified at the deposition?

A. I also served on a special committee of trustees of CREF to consider this issue from the standpoint of CREF might do in this area.

Q At page 237 of your deposition you say:

"I talked to my close friends and colleagues."

You mentioned Professor Robbins and Professor Werner.

A At Columbia.

Q You gave us their background. Now, did you do anything other than talk to these people and ask Mr. Porter to dig up the relevant information?

A I mentioned the sessions I had at CREF in which I had the benefit of other legal counsel for that organization and the field work which had been done by the staff at CREF.

Q Mr. Porter made a report to the committee

which is here, 77 in evidence. I will be glad to show it to you, sir.

MR. SCHWARTZ: Dr. Murray would not know what Exhibit 77 is.

MR. SCHREIBER: I will be glad to show it to him.

Q Here it is, Professor.

A Yes, that is the one.

Q Was there any other written report other than 77 to that committee?

A Not that I recall.

Q Just Mr. Porter's report?

A Written report. There was, of course, in the material for the annual review of the manager and distribution agreement there were further reports on this topic, but if you refer specifically to a memorandum to this specific special subcommittee, I think this is the only one that I recall.

Q Now, that report that you have before you, which is Exhibit 77, at page 1 it says that management is reviewing with the New York Stock Exchange whether recapture is permissible?

A Yes.

Q Who did that review with the New York Stock

Exchange, do you know?

A That was Mr. Porter and it might have been some additional members of the manager, but it was, I thought, my recollection is, Mr. Porter primarily.

Q But no unaffiliated directors met with the New York Stock Exchange?

A Not in connection with the Chemical Fund.

Q We are only talking of the Chemical Fund, Professor?

A Right.

Q Do you know whether Mr. Porter was told by the New York Stock Exchange that recapture through allocation of execution commissions to Eberstadt was permissible within the rules of the New York Stock Exchange?

A I do not know whether he was ever told that.

Q Do you know whether he explored any possibility of recapture through preferred rate non-membership on the Pacific Coast Exchange?

A Yes, I know that he did that.

Q What did he tell you about that?

A He told us how it worked.

Q Did he tell you it could be done?

A He told us that some other funds were doing it.

Q Did he tell you that Chemical Fund could if it

chose do it?

A He probably did, but since we had decided not to, I was not really paying much attention to whether we could do it or not.

Q That is in advance of his report about its doability or feasibility, you decided not to do it anyway?

A I knew we did not want to do it because I knew it would damage our best execution. I saw how it operated and I knew perfectly well we were not going to do it and try to save some nickels and dimes at great expense to the Fund.

Q Did Sullivan & Cromwell ever make a report to that committee in writing?

A Not to my recollection.

Q Did you consult with counsel with regard to this concept of recapture after Moses versus Bergen?

A Yes.

Q Did any other members of the executive committee consult with counsel, of the independent committee, I'm talking about?

A I presume so, because we had counsel present for some of our discussions of this whole matter.

Q Did you ever satisfy yourself as to whether the rules of the New York Stock Exchange would permit

recapture?

A I did not.

MR. SCHWARTZ: This is stipulated In the pre-trial order. I have been very patient. It is stipulated that it was permissible under the rules. I thought we would obviate going through all this.

MR. SCHREIBER: That is so, but counsel is relying on alleged business judgment, which we contend has nothing to do with this situation, and if business judgment be deemed by the Court to be relevant, which I submit it is not, I want to see the kind of business judgment that was exercised. It is only for that reason that I ask this question, for I know what is stated in the stipulations of fact as to whether or not the rules permit recapture. I have read it.

Q My question, Professor, was did you satisfy yourself as to whether recapture under the New York Stock Exchange rules was permitted?

A I did not bother to do so.

THE COURT: Dr. Murray, while Mr. Schreiber is looking for some exhibit, I want to be sure I understand the purport of your testimony. Were you so convinced that the giving of the execution contract to Eberstadt and obtaining give-ups fromthem would be so

disadvantageous for the various reasons that you set out that you would not do so, unless you were convinced that you were compelled to do it by some rule or regulation of law? That is what I glean from your testimony? Is that correct?

THE WITNESS: That is precisely an accurate statement, sir. I think that exactly follows the thread of what I have been trying to say, and that is the reason why, for example, I was not interested in pursuing some of these avenues, because I had decided no matter what the avenue permitted, we should not do it in this Fund.

Q Professor, I show you Exhibit 14, which is the April 29, 1968 prospectus and call your attention to page 8 where it is said that $61,000 was allocated to dealers, representing approximate value to dealers who had provided statistical ane research information to the manager, and it continues on to say:

"The manager has informed the Fund that these services do not reduce the expense of the manager by a material amount.'

Did you see this prospectus in draft before it was finally printed?

A Yes.

Q And approved it?

A I approved it.

Q You saw it thereafter?

A Yes.

Q In the shape in which it is before you?

A Yes, sir.

Q Tell us what you understood by the phrase "approximate value"?

A This is an estimate made by the officers of the manager of a factor in the allocation of commisions. It is an estimate on their part, on that I happen to believe personally represents an understatement, but that would only be an expression of opinion, and I do not have anything more than a general impression to support that opinion. But the responsibility was to sit down and make an estimate on a matter very difficult to define, and I could understand the difficulty, because I know that when the Fund has been dealing with a particular broker, they are dealing with him because they get the best execution, because there is investment information, because services are performed, and in these days because they were distributing shares of the Fund and it would be very difficult for anyone to say with any kind of precision that a certain proportion of the commission business given to this house was for each one of these particular services, so I under-

stood when I saw this in draft and when I approved it, that this represented an approximate value, rather than a precise calculation.

Q Can you tell me what approximate value means to you?

MR. SCHWARTZ: That has been asked and answered.

MR. SCHREIBER: He answered a lot of things rather than approximate value.

Q That meant the worth of the research provided approximately?

A Not necessarily the worth, but the amount awarded. It meant somewhere between 50 and 150,000 dollars.

Q It meant $61,000?

A It meant that this was an approximate value.

Q It meant there was $61,000 worth of brokerage commission given for the research provided?

A More times than not it was not giving it prospectively, it was evaluating commissions given and trying to unravel the factors that had made those past determinations.

Q I'm trying to see there was any value to this research. Was there, Professor?

A Indeed, there was.

Q And the approximate value stated there was $61,000?

A The value to the Fund was many times $61,000.

Q That is, they got a bargain, but .that is what they paid for it?

A They got a bargain, and the reason why they got a bargain is they were also engaging in executions with many of the same firms.

Q Approximately $61,000, unless that statement is wrong, was the allocation for resarch?

A That was assigned to it. The benefit to the Fund was very substantially greater than $61,000.

Q I'm afraid my only question to you, Professor, had to do with what it said there, the proximate falue saassigned to it was $61,000?

A Yes, that is what it says.

Q Now, it said that it did not materially diminish the expense to M. & D. Can you tell me what that meant to you?

A What that meant to me? That these services and the kinds of information obtained enhanced the quality of analytical effort and did not relieve M. & D. of work on its own. The contribution to the Fund's performance obtained by these brokerage allocations went to the

enhancement of the quality of investment decision making and not to relieving M. & D. of man hours of analytical effort.

THE COURT: Didn't Dr. Murray answer that question quite fully earlier on in your examination? He has told us why.

MR. SCHREIBER: I have no further questions, Professor.

Thank you.

THE COURT: Anything further, Mr. Schwartz?

MR. SCHWARTZ: No, your Honor.

THE COURT: Thank you, Doctor.

(Witness excused.)

THE COURT: Do you have another witness available?

MR. SCHWARTZ: Yes. Could I have five minutes?

THE COURT: Yes.

(Short recess.)

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B E R T R A N D F O X , called as a witness on behalf of the defendants, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. SCHWARTZ:

Q Dr. Fox, is it correct that since 1970 you have been a member of the board or directors of the Chemical Fund?

A That is correct.

Q What is your present occupation?

A I am a part-time management consultant. I have just retired as a member of the faculty of the Harvard Business School.

Q What position did you hold on the faculty of the Harvard Business School?

A My last appointment was the Jacob H. Schiffman, Professor of Investment Banking.

Q How long had you been a member of the Harvard Graduate School of Business -- it was the Graduate School of Business you're talking about?

A Correct. For 25 years.

Q Did you have any research function at the Graduate School of Business at Harvard?

A I was the d[illegible]ector of research at the school

for 15 years, from 1953 to 1968.

Q Before joining the Harvard faculty had you taught economics at Williams College?

A I had.

Q What were the areas of your interest during the years on the Harvard faculty?

A Mainly in the field of finance, and specifically in later years, investment banking, and before that in broad economic factors affecting business decisions.

Q Have you been in Government service?

A Yes, I have.

Q Can you describe it briefly?

A My service was full-time during the war, and preceding the war I went down to Washington in 1940 and stayed until a few moinths after VJ Day, and since then I have been on a variety of part-time assignments relating to the mobilization efforts and preparedness efforts of the Government.

Q Have you written in the area of finance and investment banking?

A Yes, a few articles, but nothing of any major importance.

Q Dr. Fox, when did you first become aware, if you ever did become aware, that it would be possible for

the Fund to use F. Eberstadt & Company as executing broker and consistent with the rules of the New York Stock Exchange to offset some part of those commissions against the management fee?

A The answer to the question specifically to the Chemical Fund, it was some time in the middle of 1970. I had been aware of it before that in connection with my being a director of the Eberstadt Fund.

Q How often during your tenure as a director of the Fund was there discussion among the board of directors about utilizing Eberstadt as a broker for the purpose of recapture?

THE COURT: How long had you been on the Fund, Doctor?

THE WITNESS: I became a member of the board of the board of directors at the April, 1970 meeting of the stockholders.

THE COURT: You have been on the board since then?

THE WITNESS: Yes, I have, sir.

Q How often has the subject been discussed since that time?

A At least once a year, and in some years more often than once a year. When I say at least once a

year, it has always been a part of the consideration of the unaffiliated directors of the Fund in their review of the management and distribution agreement and in a report, a written report, of a subcommittee of the unaffiliated directors to the rest of the unaffiliated directors in relation to this.

Q In your years as a director is there at least one written report each year covering the subject of recapture?

A Yes, sir.

Q Who is it that determines the Chemical Fund policy with respect to brokerage?

A The board of directors.

Q Could you state to the Court briefly in general terms what is the firm's brokerage policy and what has it been since you became a director in 1970?

A Two elements have been constant throughout that period. One is that all brokerage should be allocated in such a way ss to get the best price and execution in connection with brokerage transactions, and the second is that no part of the brokerage arising from the Fund is to be allocated to the parent firm, F. Eberstadt & Company, Inc.

Another one stated constant is the possibil-

ity of using brokerate to obtain research ideas, investment ideas from other brokerage houses, and one which was changed during the period for the early years, brokerage was allocated to some extent to get, or, rather, to reward those brokers who were doing the best selling job of the Fund, but in later years that was ruled out by the SEC, and I think from that time on the policy of the board was that sales of the Fund shares should be neither a qualifying or disqualifying element as to allocation of brokerage.

Q Let me isolate, if I may, one aspect of the Fund's brokerage policy as you just stated it, that aspect being there should be no brokerage executions through Eberstadt. Was this a decision which you as a director of the Fund participated in?

A It was.

Q What was your view on the subject?

A Probably the most important reason in my mind was that I thought that all investment decisions should be made for the Fund without any possibility of being influenced by the possibility of obtaining additional brokerage revenue. I wanted a complete separation of the investment function, the brokerage function. I wanted no possibility of being accused or of the Fund being accused of churning the portfolio to generate

additional brokerage. And although it is my strong belief that the officers of the Fund have the same view in this respect, I wanted to make sure that there was no possibility of it and that the public understood that there was no possibility of it, so the reputation of the Fund would be clear in this respect.

Second, I don't think that the Eberstadt firm by itself could obtain the best execution and price for all of its transactions. It probably would be able to for some, but many other firms are a good deal more expert in particular securities, follow them, are able to get better execution in price than the Eberstadt firm in several kinds of transactions.

Third, I think you sacrificed the opportunity to supplement your own research through the research ideas of others which you can obtain through the allocation of brokerage.

And, fourth, you sacrifice the possibility of getting or giving additional incentive for sales of the Fund shares.

Those are my four reasons. The most important in my mind is No. 1.

Q The apparent conflict of interest?

A The apparent conflict of interest.

Q Did you give any consideration when these matters were being discussed to expected changes in the structure of the securities markets?

A Yes. There were many discussions of that, especially the possible impact in the future of the change in the commission structure, the various recommendations that grew out of the Martin report as to the change in the character of the securities business, various pending legislation in the Congress relating to the changes in the structure of the securities markets, the development of a few central markets, and so on and so on. There were a variety of things which were in the air and which were discussed at various times by the directors.

Q Let me ask for a moment about the Martin report which is in evidence.

Is it correct that one of the recommendations of that report was a report of the Board of Governors of the New York Stock Exchange that in the future member firms of the Stock Exchange would not be permitted to act as managers of an investment company?

A In essence, yes. My memory is that the recommendation was that member firms which had a mutual fund affiliate should divorce themselves from or have that affiliate divorced from the brokerage firm, but it had the

same effect.

Q What impact or what effect did that recommendation have upon your consideration of the Fund's brokerage policy?

A It reinforced our judgment, because this is essentially the same judgment we had reached, that there should be a complete separation of the two.

Q Have you ever heard a decision by the United States Court of Appeals, First Circuit Court, called Moses against Bergen?

A Yes, I have.

Q Did you read it at or about the time it was handed down?

A I don't recall whether I read the entire decision in detail or not. I certainly read summaries of it and I was aware of the contents. I don't recall whether I read it in detail.

Q Who advised you of the fact that the decision had been handed down?

A I think it was the management of the Fund, M. & D.

Q Were you a member of the subcommittee of the board of directors charged with reconsidering brokerage policy in light of Moses against Bergen?

A I was. If my memory is correct, it was a tree-man subcommittee appointed in June, I think it was, of 1971.

Q A good recollection, Dr. Fox.

What was the conclusion of the committee after its deliberations?

A I don't think the committee ever made a formal written report. The committee, if my memory is correct, represented a kind of combination of two separate committees, one of which was the committee to review the management agreement of the Eberstadt Fund, and there was Roger Murray and myself, and the other subdcommittee, which had a similar function for the Chemical Fund, consisted of Roger Murray and Alfred Driscoll, so that these two committees, I think, were put together for this purpose.

Somewhere late in the summer of 1971 various developments were taking place in Washington, the SEC, and both the Senate and the House Subcomittee relating to brokerage and allocation of brokerage and changes in the commission structure, and I know the management of the Fund recommended to the board that no changes be made in our system of allocating brokerage until we saw more clearly what the results were of these activities going on in Washington. The board concurred in this recommend-

ation, although in the next month Roger Murray and I as a subcommittee for the Eberstadt Fund came out with explicit recommendations that we continue our policy of not having any brokerage allocated to the Eberstadt Fund and --

Q To the Eberstadt firm?

A To the Eberstadt firm. Excuse me. And that we get an amendment to the charter of the fund to make explicit that the power to determine brokerage allocation policy be a power of the board of directors. And we made that recommendation to the board, and this did take place at the meetings of the fund shareholders in early 1972.

Q This is Chemical Fund shareholders?

A Chemical Fund shareholders. And earlier than that, the Eberstadt fund.

Q Could you describe, please, the legislative developments which you considered? You enumerated them before.

A There was a report of the SEC to two subcommittees of Congress, one the House and one the Senate. The Moss Committee in the House and the Williams Committee in the Senate -- I have forgotten the technical names of them -- giving the SEC recommendations following, oh, a seven or eight-year investigation that they had been making of the investment fund industry, and then I knew of hearings which had been taking place on both the Moss Committee and the Williams Committee, and a report of the Williams Committee and proposed legislation by the Williams Committee relating to brokerage.

Q Well, what aspects of that legislation particularly concerned you?

A The one very, very explicit one related to the possible institutional membership on the New York Stock Exchange, and I think it had the stipulation in it that if institutions investment institutions were allowed to become members, they should not be allowed to do any brokerage for their own account.

So that's the separation, the same kind of separation that we advocated and adhered to in Chemical Fund.

MR. SCHWARTZ: I have no further questions.

MR. SCHREIBER: May I have just a moment to consult?

CROSS EXAMINATION

BY MR. SCHREIBER:

Q Dr. Fox, I believe you testified that you came on the board of the fund in April of 1970.

A That's correct.

Q Of course, you had nothing to do with give-ups?

A That is correct.

MR. SCHREIBER: No further questions.

MR. SCHWARTZ: I have no further questions.

(Witness excused.)

MR. SCHWARTZ: Your Honor, rather than put on eight other unaffiliated directors, whose testimony will be almost

the same as the two that you have heard, the defense rests.

If Mr. Schreiber wishes to put on Mr. Dorsett in rebuttal, another outside director, I will do my best to make him available tomorrow afternoon or Thursday afternoon. I willknow tomorrow morning whether I can get him at that time.

THE COURT: I will not be able to hear this matter until 3 o'clock, in any event. We can go on tomorrow at that time.

MR. SCHWARTZ: If Mr. Schreiber wants Mr. Dorsett at 3 o'clock tomorrow, I will try to produce him. I can't be sure. If not tomorrow, it will be Thursday.

MR. SCHREIBER: If your Honor would prefer to have it Thursday, it is equally convenient for me.

THE COURT: Well, I am here, anyway.

MR. SCHREIBER: Yes. You have to go to work, anyway.

THE COURT: I will be available as of 3 o'clock.

MR. SCHWARTZ: Why don't we put it down for 3 o'clock tomorrow, and if Mr. Dorsett for some reason finds it impossible to come, we can set it down for Thursday.

THE COURT: Is that going to be the extent of your rebuttal?

MR. SCHREIBER: That's right, sir.

THE COURT: Then it is contemplated that this case

will be over by Thursday?

MR. SCHREIBER: Much to our surprise, we do so contemplate.

I gather that it is not unpleasant news to the Court.

THE COURT: It is not. As a matter of fact, I want to congratulate you and Mr. Schwartz, except that I gather I have to go to work on some 160 exhibits.

MR. SCHWARTZ: I suspect that your Honor will not pause long over the great bulk of them.

MR. SCHREIBER: I expect that is true.

THE COURT: All right. We will adjourn, then, and you will let me know tomorrow morning.

(Adjourned to December 18,1974, at 3 P.M.)

WITNESS INDEX

Name	Direct	Cross	Redirect	Recross
Robert G. Zeller (Resumed)		96	128	131
Robert M. Maynard	[illegible]	149		
Robert F. Murray	156	180		

SUSAN TANNERBAUM

vs. 71 Civil 2104

ROBERT C. ZELLER et al.

New York, December 18, 1974;
3.00 o'clock p. m.

(Trial resumed.)

- -

THE COURT: Mr. Schreiber, you may proceed.

MR. SCHREIBER: Yes, your Honor.

I call Mr. Dorsett.

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B U R T D O R S E T T , called as a witness by the plaintiff in rebuttal, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. SCHREIBER:

Q Mr. Dorsett, will you state your age for the record?

A I am 44.

Q You have been a director of the Fund since 1966?

A Right.

Q Will you tell the Court your educational background?

A Grammar school, high school, Dartmouth College and an M.B.A. from Harvard University, School of Business.

Q After the School of Business at Harvard, what did you do?

A I went to work for Booz, Allen, Hamilton in New York, a consulting firm.

Q And how long did you stay with them?

A Almost three years or three and a quarter years, something like that.

Q When did that period end?

A March of 1962.

Q What did you do after March of 1962?

A I went to work for the University of Rochester.

Q How long did you remain with the University of Rochester?

A Approximately eight years, until October of 1970.

Q In what capacity?

A I went down there as an investment officer -- I believe that was my title -- managing the University of Rochester's endowment.

Q Did your title change until you left, in October

of 1970?

A Yes; I did. I became the vice-president for investments.

Q Was that the office you held when you left?

A Yes.

Q How did you come to leave the University of Rochester?

A Well, I was a trustee of the T.I.A., the College Retirement Equities Fund, and I was on the ad hoc committee, where we decided to restructure the organization for College Retirement Equity Fund, and in the process of doing the restructuring I got quite interested in the funds that were opening up there directly and was asked if I wouldn't come down and manage the College Retirement Equities Fund.

Q What is your present position?

A Executive vice-president, College Retirement Equities Fund.

Q How did you come to become a director of the Chemical Fund?

A I really can't answer that. I can only answer in terms of what I know, which was that I knew most of the people at Eberstadt, particularly Bert Eberstadt and Peter Cannell, and I just got to know him quite well,

and my boss at the University of Rochester was a director of the Chemical Fund. I believe it was in 1964, he could no longer serve on the Chemical Fund Board -- I'm not sure of the date, but it's around that time, I think -- because he was then going to be serving on the trust committee of the First National City Bank, and he could not carry those two positions at the same legally, so after he went off the board I was asked if I would care to join in his place.

Q Who asked you that?

A I believe it was Bert Eberstadt.

Q And you accepted and became a director?

A Yes.

T2 Q During your period of service as director of the fund have you served on any of its committees?

A Yes.

Q Which?

A The portfolio committee, I believe, almost since the time I went down. There might have been a slight delay getting on the portfolio committee. Perhaps there was a delay of one year. And I served on the audit committee which was set up in about 1969, I believe. I'm not quite sure, '68 or '69, I served on that committee for about three years, I believe.

Q Any other committee?

A I'm trying to think if there is another committee.

Q I was about to ask that. I don't know of any. Do you?

A I don't know of any.

Q You are what is termed an unaffiliated director?

A Disinterested director, unaffiliated, yes.

Q What proportion of your time do you spend on the affairs of the fund?

A Well, I would imagine it would run maybe ten hours a month roughly, sometimes a little more, sometimes less.

Q Would you say you spend as much time on the affairs of the fund as any of the unaffiliated directors?

A I would say I probably spend more time on the fund than most of the unaffiliated directors.

Q Are there any of the unaffiliated directors whom offhand you would say spend more time than you?

MR. SCHWARTZ: I object to that. It is not within his testimonial capacity.

THE COURT: Objection sustained.

Q As an unaffiliated director, Mr. Dorsett, do you endeavor to be fully aware of what is going on at the fund?

A I try to be.

Q Do you own any stock in the fund?

A Yes.

Q How many shares?

A I think somewhere under 600 -- 596, something like that.

Q Do you have any notion of the current market worth of the shares of share?

A Yes, I believe it's around $7 a share, so that would be roughly $4,200.

Q This is not your largest personal investment, is it?

MR. SCHWARTZ: I object to that. It is irrelevant, no part of the rebuttal case.

THE COURT: Objection sustained.

Q Since you have testified at your deposition in

this action on September 11, 1974, have you had occasion to read the transcript of your testimony?

A Yes.

Q Have you discussed your earlier testimony with anyone?

A No, I don't believe so. I did mention that I thought there were a couple of things that were wrong in it and so mentioned it to my attorney.

Q You discussed it with your attorney?

A Just those couple of things.

Q That you thought were wrong?

A Yes.

Q Would you like to check them? Do you recall what they were?

A I recall what one was. It had to do with my compensation at the fund.

Q I think at the time of your deposition you stated that you thought your compensation was either a quarterly or an annual payment of $2750? Is that correct?

A Yes.

Q I think that appears at pages 326-7 of your testimony.

Do you now recall what the proper amount is?

A Well, I believe I was given you what the compenation

was back when I first went on the board. Our compensation has now been changed as of, I guess, last year, and as of now the compensation is $4500 per year, as a stipend, I gue , or something like that, and $200 per meeting for the fund itself. And then the portfolio committes is $3,000 a year and $100 a meeting as of some time last year.

Q Are you now on the portfolio committee?

A Yes.

Q So that your base compensation is $4,500 as a director?

A Right.

Q $3,000 as a member of the portfolio committee?

A Right.

Q Plus $200 for attendance at each meeting as a director?

A Yes.

Q How about each meeting of the porfolio committee?

A $100.

Q Does the audit committee receive separate compensation?

A Yes, but I am not a member of the audit committee and I don't know what they get paid.

Q Is there anything else you want to correct that you can think of offhand?

MR. SCHWARTZ: You have been given the changes in the transcript.

MR. SCHREIBER: I don't mean typographical corrections.

Q Is there anything of substance?

A I don't think so.

Q During the 1965-68 period do you recall whether or not customer directed give-ups were used by the fund?

A Customer directed give-ups.

Q Do you know the meaning of the phrase customer directed give-ups?

A I would like you to repeat what the meaning is.

Q Have you heard the phrase before?

A Yes.

Q Would you tell me your understanding of the meaning of customer directed give-ups?

A I believe it is when you give an order to a broker and demand that he give certain portions of that commission over to other brokers.

Q Would those other brokers be people who do or do not participate in the execution of the transaction?

A People who don't participate, although conceivably we could meet on the floor in a prearranged fashion.

THE COURT: Mr. Schreiber, I am really not interested

in a sort of abstract problem of Mr. Dorsett's knowledge or lack of knowledge. I think the issue is whether he knows what the practice is.

MR. SCHREIBER: Your Honor is absolutely correct. I merely asked that as a prelude to finding out whether or not these customer give-ups were used by the fund during the period.

THE COURT: You can ask it.

MR. SCHREIBER: I only ask it so that we use the same term meaning the same thing.

Q With that meaning as you understood it, were customer directed give-ups used by the fund in the period 1965 through 1968?

A I don't know.

THE COURT: The answer is you don't know.

THE WITNESS: I don't know.

Q Do you know whether in the 1965 through 1968 period the fund was directing any of its execution business to Eberstadt and Company?

A I know they were not.

THE COURT: I understand Mr. Dorsett has been a director since 1966.

MR. SCHREIBER: That is correct.

THE COURT: You're asking about something that

he can only know by hearsay.

MR. SCHREIBER: '65 through '68, sir, is my question.

THE COURT: It seems to me it should be '66 to '68.

MR. SCHREIBER: I will pinpoint it '66 through '68, until December 5, 1968.

Q Do you know whether the fund was using customer directed give-ups?

A I don't know.

MR. SCHREIBER: Thank you, your Honor, for the correction.

Q In the period when you were on the board in 1966 through to the present time do you know whether the fund directed any of its execution business to Eberstadt & Company?

A I know they did not and have not.

Q During that same period do you know whether the fund recaptured any commissions on portfolio transactions through use of preferred rate non-membership on the Pacific coast?

A I know they did not and have not.

Q You are aware, and since you are a member of the board have been aware, of the possibility of the recapture of commissions or portions of commissions on portfolio

transactions as a device to reduce the advisory fee?

A I have been aware of it. I'm not sure that I have been aware of it from the first day that I went on the board. But I was certainly aware of it some time in '67. Perhaps I was aware of it all the time.

Q I show you Plaintiff's Exhibit 74, which is a January 9, 1967, memorandum to the board of the fund written by M & D and ask you if you received that document at or about the time it is dated?

A Yes, I did.

Q My question, sir, is, did you receive that document on or about January 9, 1967?

A Yes; I did.

Q And did you read it?

A Yes.

Q Did you read also the PPI report which is referred to in 74?

A I may have read some parts of it. I certainly didn't read -- you are talking about that report in your hand?

Q Yes. Since I have it in my hand, I will show it to you, and I will mark it for identification.

A I probably read some parts of it, but not the whole thing.

Q You are certain you read some parts of it?

A Some parts, yes.

MR. SCHREIBER: Will you mark this as Plaintiff's Exhibit 162 for identification.

(Plaintiff's Exhibit 162 was marked for identification.)

Q I will call your attention, Mr. Dorsett, to your testimony at your deposition, September 11, 1974, at page 270:

"Q Had you previously seen the PPI report

of the SEC which was issued under date December 2, 1967?"

That is the same document which I just showed you.

"A Yes. I believe I did see that report.

"Q Did you read it through?

"A I probably did."

You only read parts of it?

A That's true.

Q Did you read that part of it which is referred to at page 6 of 74? I quote the sentence:

"The SEC apparently look with favor on the practice of using brokerage business on portfolio transactions to reduce the cost of management."

A Yes.

Q You did?

A Yes.

Q Did you subscribe to the view that brokerage business should so be used?

A No.

Q Why not?

A Well, I felt -- there was a lot of reasons. Certainly, you can start off by saying all the brokers -- all the brokerage business could have been transacted through F. Eberstadt & Company, as I so testified before

in the deposition. I did not agree with that kind of practice, that is Eberstadt should do any of the business -- I felt they should not do any of the business.

Q You mean the business of executing portfolio transactions?

A Right.

Q Now, will you be good enough to tell us why?

A I just think it gets to be a conflict of interest. Particularly when you've got so many conflicts of interest in our business, I think any one that can be avoided should be avoided. I believe that's probably the main reason. I had some others, such as I felt it would be debilitating to management, it would take their focus of a true shareholder, somewhat taken them out of focus. Our primary interest is doing the best job for the shareholders.

Q Take the shareholder out of focus?

A That means an appearance -- yes. The shareholders should come first.

Q Was there any other reason why you should not direct execution business to Eberstadt? You mentioned conflict of interest, debilitation of management. Anything else?

A Conflict of interest -- I'm sure I probably

could think of them if I had time, but that's adequate.

Q Is that all you can think of now?

A Yes.

Q Those reasons continued down to date as reasons why Eberstadt should not execute brokerate business for the Fund; is that right?

A Yes.

Q And are those the reasons that compel you today to feel that that should not be done?

A Yes.

Q Now, will you be good enough to tell me what you mean by conflict of interest?

A Churning the account, for one.

Q Anything else?

A I think that's enough in itself.

Q It may or may not be, sir. I just want to know.

Do you have any other aspect of conflict of interest other than churning of the account?

A None that I can think of right now.

Q Now, you say it would be debilitating to management. Can you tell me what you mean by that, sir?

A Here again, I think you are -- it's somewhat connected with the conflict of interest. You're worried

more about how much money you can make on an account as opposed to really putting the shareholder first. You carry on a bunch of wash sales in the Fund, for no reason at all, just for doing a lot of business.

Q By "carry on wash sales", you mean they buy and sell the same security just to generate commissions and make the broker rich?

A Yes.

Q Didn't you have a portfolio committee at Eberstadt that would have prevented that -- pardon me -- I mean a portfolio committee at the Fund that would have prevented that?

A I don't believe the portfolio committee has ever got into the reviewing of commissions until the audit committee started doing it.

Q You were a member of the portfolio committee for three years, I believe you said.

A No. I have been a member of the portfolio committee going on now eight years.

Q Thank you for the correction.

It was the audit committee on which you served for just three years?

A Yes.

Q Now, on the portfolio committee, wouldn't you

notice that there had been a purchase and sale of the same security, a wash sale?

A I don't believe we would have noticed that -- oh, a wash sale we would have.

Q You would have. So there was no danger of a wash sale as an item of debilitation of management that you were talking about, because the portfolio committee would have stopped that?

A Maybe yes, maybe no, because you could still wash -- you could still have wash sales and generate a capital gains for your shareholders.

Q Do you mean --

A And that possibly could be justified.

Q I see. But the fear that you had was that wash sales that were not justifiable would be done in order to increase the commissions of the executing broker, Eberstadt if he were the executing broker?

A Yes.

Q That kind of thing would be stopped by the portfolio committee, wouldn't it?

A That's really one thing. I was talking about churning the account.

Q We will get back to that. I am talking about wash sales. There couldn't have been wash sales, because

the portfolio committee --

A I just told you about wash sales that did take place. Why do you tell me it couldn't? I just told you that there could be.

Q In order to realize a gain.

A Yes.

Q But there couldn't be a was sale just to generate commissions, because the portfolio committee would have taken care of that?

A A wash sale for a capital gain is still for the interest of the shareholder.

THE COURT: Mr. Dorsett, let me interrupt.

Assuming that sound business judgment and the exercise of sound business judgment is the critical point, isn't the issue whether or not the directors exercised that judgment in good faith? By hindsight we could find out that the judgment was based on something else. That is what I am trying to find out.

All the witnesses have raised the point about conflict of interest. You have contested that. We are not getting anywhere on it, because it just reduces itself to argument, because the directors feel that they are correct, and what I am trying to find out is whether we are getting involved in that because they withheld their

judgment and upon analysis if they exercised good faith that that would be sufficient.

If that is not the issue that is going to control in this case, then we can disregard it. It is your contention that sound business judgment -- well, I am not going to cut you off, but it just seems to me that we are not getting anywhere, while you are getting Mr. Dorsett to in effect argue with you about the basis of his intentions.

MR. SCHREIBER: Your Honor, I may say that in my opinion, whether it involves give-ups in the 1965-to-1968 period, and certainly in that period, but even in the subsequent period, where it involved failure to directly allocate and recapture by giving commissions to Eberstadt, in neither period is business judgment a defense, the more so in the give-up situation, possibly the less so since '68.

However, your Honor -- may I approach the bench and discuss this with the Court outside the hearing of the witness?

THE COURT: All right, Mr. Schwartz.

(At the bench:)

MR. SCHREIBER: Should it be determined by the Court that business judgment is a defense in any part for

any time spent, I think I can demonstrate through this witness his utter incapacity to exercise business judgment, because he was uninformed.

THE COURT: All right.

MR. SCHWARTZ: The documentary record which Mr. Schreiber himself put in shows that this man wrote and participated in the reports on recapture each year.

MR. SCHREIBER: His name was on the reports.

THE COURT: I only hoped you would agree with me, but obviously if you think it is important, it hasn't been that long a trial for me to cut you off, anyway.

MR. SCHREIBER: Thank you, your Honor.

(In open court:)

Q Mr. Dorsett, getting back to this wash sale concept, just so you can straighten me out on it, you feared debilitating management because management might go through wash sales just to create commissions?

MR. SCHWARTZ: I object to it. It is a mischaracterization of the witness' testimony and improper cross-examination.

THE COURT: Rephrase your question, please, Mr. Schreiber.

Q Mr. Dorsett, you told me what you feared about wash sales as debilitating management.

A You are really taking a very small piece out of what I totally said. I talked about total churning of the account. Then I mentioned wash sales. I believe that was the order in which I put them, and that's indicating that that would have been wash sales.

I am saying conceivably they could conjure up a reason for a wash sale, and the reason could be that they could get a capital gains and therefore do a little more commission business.

Q But your real fear was churning of the account?

A Churning of the account, conceivably. There are other things debilitating as well, such as execution. Just a simple execution, where you are going to get the best execution which we are after for our shareholders, and I'm not going to indicate to you that Eberhardt & Company is the best executioner on every kind of sale in that portfolio. I can tell you they are not.

Q Any other instance that you want to get to of debilitating management before we go back and examine them?

A Yes. I think there are other reasons why we paid out our brokerage the way we did it, and that happens to be for research as well as by best execution.

Q Qnything else besides research?

A Sales.

Q Anything else?

A No. Not that I can think of.

Q Statistical?

A Perhaps, yes.

Q Now, this here you had that using Eberstadt as the executing broker might lead to churning: Was that a view shared by the other unaffiliated directors?

A I don't think it was a view that was -- that we were totally concerned that was going to happen. We just wanted to avoid any appearance or any impression that that might be happening. That is important to our Fund sales, and I believe in the spirit of doing things neat, clean, without any obligations internally.

Q By using executing brokers other than Eberstadt, the Fund or its M. & D. manager was able to direct executions to brokers who rendered sales or research services?

A I believe they could, up until 1968. Wasn't that when they did away with the commission -- I mean, the give-ups?

Q Yes. That was in '68.

A They did away with the give-ups.

Q Did they direct give-ups prior to the end of 1968?

A I have told you, I don't know.

Q You don't know. You don't know anything about the direction prior to 1968?

A No.

Q Did they direct commissions on portfolio transactions, actual executions, at all times right on down to date, to brokers who helped with research?

A Yes.

Q Did they direct commissions to brokers who helped with sales at all times?

A Yes. Not up to today.

Q Until middle 1973?

A Middle 1973.

Q And you are aware of that practice?

A Yes; I am. However, let me just qualify this. Providing it was based upon best execution. That was the number one priority.

Q Now, with that reservation, that it was based upon best execution, was it useful --

MR. SCHREIBER: Strike that.

Q Was that ability to direct brokerage to brokers who provided sales until '73 or research -- was that a resource of M. & D.?

MR. SCHWARTZ: I object to that. He is asking a legal conclusion of this witness. He is going into

legal argument. I don't think it is a fact question.

THE COURT: Yes.

MR. SCHREIBER: I will withdraw the question, your Honor.

Q I will read into the testimony from page 307:

"Q That is, you recognize" --

MR. SCHWARTZ: I object to that, your Honor. It is not impeachment that he is reading from.

MR. SCHREIBER: I am rading from his testimony.

THE COURT: Well, he is offering it --

MR. SCHWARTZ: Is he reading this as an admission?

THE COURT: He has a right to use the deposition.

Q (Continuing) "Q That is, you recognize the allocation of the purchase and sale orders as an additional resource to M. & D.; is that not correct?

"A Right."

(Recess, during which another matter was heard.)

Q (Continuing) Before we had this brief recess, Mr. Dorsett, I read into the record from page 307 of your prior testimony a question as to whether the allocation by M. & D. was an additional resource to M. & D.

Did you understand the meaning of "additional

resource" at the time I questioned you?

A Yes.

Q And you understand it now?

A Yes.

Q What is your understanding?

A That it is an additional resource to M. & D.

Q What do you mean by an additioan resource, sir?

A It could be used to pay off sales, to pay off research.

Q Used by M. & D.?

A M. & D.

Q And a resource being a thing of value?

A Yes.

Q Do you know who selected the brokers who received the commission business for executing portfolio transactions?

A M & D.

Q Among the reasons that you gave for not using Eberstadt at the executing broker for the fund was that you were not sure that Eberstadt could in all instances give best execution?

A That is certainly one of the reasons.

Q Eberstadt did execute for other clients, did it not

A Yes.

Q Was it your opinion that Eberstadt in some instances could have given the fund best execution?

A Equal.

Q As good as any?

A In many cases, yes.

Q Would this conflict of interest of which you spoke apply also if Eberstadt were to credit its profits on execution against the advisory fee that the fund was paying M & D?

A What is the question?

Q Would the conflict of interest nevertheless apply if the profit on commission business were to be credited by

by Eberstadt on the advisory fee payable to M & D?

A Yes, I believe it would. There is still some conflict involved there.

Q Can you tell me what conflict would then exist?

THE COURT: Mr. Dorsett, will you speak up a little so I can hear you.

THE WITNESS: Okay. I'm sorry.

I would have to think the whole thing through, but, certainly, there is a conflict in just getting the resources. These moneys you are talking about were fairly insignificant. Secondly, we did have to pay for certain resources.

Q Who is "we"? M & D?

A M & D, and these resources being as I indicated, sales. It was a common practice in the trade to have the fund pay off for sales efforts by using their brokerage business. Our turnover was extremely low in terms of our brokerage business on this fund. As I have indicated, the shareholder was the key person that we were concerned about, and then you would have to get into the judgment area. Each time you did a sale you were debiting the management, each time we are going to execute a sale, obviously, they are going to think that is the best, but that may not be true, and so you avoid that totally by telling them they got to

do their business outside. Then they got all these other brokers that they can pick and choose from. There is a real conflict in what you are talking about here of just doing it and passing it off as a reduction on the fee. I don't believe that reduction came in until '67 or something like that, and that was because people were putting it in their own pockets, as I recall, their brokerage business.

Q What do you mean the reduction didn't come in until 1967?

A I believe people were not asked to reduce their fee directly until that case came in, the one that you're referring to there.

Q You mean Moses v. Bergen?

A I don't know. One of those cases.

Q This one that was decided up in Boston?

A I think so. I'm not sure. But that was the first time that I was aware that people were not to put it in their pockets, that they were supposed to give it back.

Q That case was decided in 1971, Mr. Dorsett. Does that help you?

A So you're laughing. I don't know when it was.

Q I'm not laughing. I'm trying to help you.

A All I am saying is there were some cases that were going to go to court or maybe they were in court. I don't

know which cases they were. But the point is most people-- and if you say it was '71, then I believe it was probably '71 -- before anyone started to reduce their fee in a purposeful manner, of doing brokerage to reduce their fee. Therefore, all the business would have been going to F. Eberstadt & Company, which I have already told you I would not have tolerated. I would not have been a director of that fund.

Q Would you not have been a director of the fund if some of that business went to Eberstadt for the purpose of recapture to reduce the advisory fee?

A No, I don't think I would.

Q You were against that, too?

A I was against that, yes. I am against that.

Q As a member of the portfolio committee do you keep an eye out to prevent churning?

A It has never come up, because, certainly we would. That is one of the reasons of our being an unaffiliated director, we would certainly try to avoid that.

Q The portfolio committee would recognize churning if it were taking place?

A I don't know if we would really recognize it. We try to exercise good judgment, but, you know, I just really have not found a way to avoid fraud if there is going to be fraud.

Q Does the portfolio committee see all purchases and all sales?

A Yes, they do.

Q And seeing all purchases and all sales, they can see whether the same security were being bought and sold?

A No. You're talking about a wash sale. I'm just talking about general churning.

Q I'm not talking about a wash sale; I'm just talking about the supervisory function of the portfolio committee. Could they tell whether there was churning, too much turnover?

A How much is too much? I believe our record will indicate -- I really shouldn't, really throw out a figure-- it has been as low as 3 per cent and as high as 8 per cent on occasion.

Q Per year?

A Per year.

Q And 8 per cent as far as you can recall was the highest portfolio turnover any year?

A I think that would be it, but I'm not sure about that. Therefore, I would not like to be quoted.

Q Could it be three or four times as great?

A No, we never had that kind of turnover.

Q It could be as low as 3 per cent?

A I believe that is true.

Q Did you know that as early as 1967 some funds were using preferred rate on the Pacific coast to reduce their advisory fee?

A I didn't know that in '67, no.

Q The PPI report points out -- I am quoting now from Exhibit 74 which you have read -- that IDS is now a member of the Pacific Coast Exchange with the fund receiving the full profit on its brokerage business, and the United Fund Group is also a member of the Pacific Coast Exchange with the fund receiving 50 per cent of the profit.

You knew that in 1967, didn't you?

A I guess I did, as soon as it was in there.

Q Did you do anything to see whether Chemical Fund in 1967 could make a like saving in its advisory fee?

A No, for the reasons I already indicated we didn't wish to do our own business, we didn't wish to have give-ups coming back to F. Eberstadt & Company.

Q And preferred rate non-membership recapture on the Pacific coast would have involved using Eberstadt for execution?

A I believe what you are suggesting is F. Eberstadt & Company recapture some of its business that they directed to other brokers? Is that what you are suggesting?

Q You know what preferred rate non-membership on the Pacific Coast Exchange is, do you not?

A Yes.

Q You know that M & D was an NASD member in '67?

A Yes.

MR. SCHWARTZ: Would your Honor direct Mr. Schreiber to return to the lectern?

MR. SCHREIBER: I will be happy to go even farther.

Q You knew in '67 M & D could have obtained preferred rate non-membership on the Pacific coast and thus recapture a portion of portfolio commissions on that exchange without involving Eberstadt, did you not?

A I know it would involve Eberstadt.

Q It would involve Eberstadt?

A Yes.

Q Even though M & D was the one to apply for and obtain it?

A M & D then --

Q M & D and Eberstadt are really the same thing?

A I was thinking of Eberstadt as being an NASD member, whereas it is M & D.

Q Well, Eberstadt is also an NASD member, isn't it?

A Right -- is M & D -- I don't know -- is M & D an NASD member.

Q If I may, NASD stands for National Association of Security Dealers?

A Would you answer my question?

Q Well, they were both members of NASD.

A Thank you.

MR. SCHREIBER: And M & D could have applied for preferred rate Pacific coast non-membership privileges without involving Eberstadt & Company.

I don't mean to testify, your Honor; I am merely trying to answer the witness' question.

Q I can understand your confusion.

MR. SCHWARTZ: Your Honor, may I ask leave to caution Mr. Schreiber that he is a lawyer questioning a witness, and the purpose of the witness coming here is not to be abused.

MR. SCHREIBER: I would not want to abuse Mr. Dorsett.

THE COURT: I asked before all editorial comments be kept to yourself and just question the witness, Mr. Schreiber. Please proceed.

Q At page 301 of your testimony, foot of the page, line 23, I asked you:

"Q Do you know whether Mr. Van Der Venter was paid by the fund a salary?

A No, I never did get the fund and the M & D thing all straighted out in my own mind. I believe the fund has a contract with M & D, and, therefore, we pay M & D and M & D pays their employees. I am quite sure that is how it works, but you're getting very technical with me now."

Do you recall giving that testimony?

A Yes.

Q You have M & D straightened out as against the fund now?

A If you get too technical with me perhaps I don't.

Q You recall that M & D is the manager?

A Yes, I do.

Q Or adviser?

A Yes.

Q And you recall the fund is the entity in which the public buys shares?

A Yes.

Q You recall that Eberstadt is the broker that owns the stock of M & D, the firm that owns the stock of M & D?

A I believe that is right. I don't see what it has to do with this whole case, but go ahead.

Q In 1965 and continuously to date do you know that Eberstadt has been a member of the New York Stock

Exchange?

A From 1962 I believe they have been a member.

Q And that would include from '65 to date, of course?

A Yes.

Q Do you know whether the rules of the New York Stock Exchange would have permitted the fund to recapture a portion of the commissions paid Eberstadt on portfolio transactions had such business been directed to Eberstadt?

A Would you repeat the question again?

Q I will try to rephrase it and make it more simple, if I may.

Throughout this period that you have been a director, from 1966 to date, do you know whether it would have been possible without violating the rules of the New York Stock Exchange to have the fund direct brokerage business to Eberstadt and have Eberstadt credit to the fund a portion of the brokerage commissions against the advisory fee paid M & D?

A I believe they could do that.

Q And if not violate the rules of the New York Stock Exchange?

A I don't think so.

Q Did you ever discuss that with any of the other directors of the fund?

A Yes, we discussed it on occasion. I believe our audit report would indicate that we discussed that subject almost every year since the other committee was formed.

Q In your deposition I asked you at page 321, line 17:

"Q And do you recall discussing the possibility that Chemical Fund might work out an arrangement to reduce the advisory fee by allocating brokerage commissions to Eberstadt?

"A Yes."

At page 323 on the same subject, line 9:

"Q You do not know whether the rules of the Stock Exchange would have permitted an arrangement whereby the commissions derived through Eberstadt, by Eberstadt through portfolio transactions of the fund, could have been credited against the advisory fee?

"A I believe as an NASD member I am not sure because they are a member of the New York Stock Exchange, but I believe as a NASD member they could get it if they perhaps got off the board or something. I am not quite sure how that arrangement works.

"Q You do not know whether they could get it as a New York Stock Exchange member?

"A No.

"Q Did you ever find out?

"A Did I? No, because I didn't feel the practice when we could get it warranted that kind of action."

Do you recall that testimony, sir?

A I recall the day. I don't recall the testimony. If it is there --

Q Have you made any further inquiry since that testimony whether the New York Stock Exchange rules permitted recapture?

A No.

Q Do you know whether at any time the management of the fund made any inquiry as to whether recapture of brokerage commissions would be permitted by the New York Stock Exchange?

A It was immaterial because I didn't want to have that done in that way; I didn't want any business going to F. Eberstadt & Company. I said that three times here.

Q I understand. My question to you now is whether management, M & D or the fund, ever made any inquiry?

A I am sure the fund knew ways they could recapture if they so desired.

Q At page 324, line 9:

"Q Do you know whether any such review was made by management with the New York Stock Exchange?

"A I don't know.

"Q Did you ever discuss who was going to review with the New York Stock Exchange the interpretation of that existing rule?

"A I don't know whether it was going to be an officer of the fund, which also probably would have an officer of M & D, or whether it was to be handled -- therewas ICO, the organization that handles mutual fun's--

"Mr. Schwartz: Investment Company Institute.

"The Witness: Investment Company Institute.

"Q The answer is you don't know?

"A I don't know."

Do you recall that testimony?

A Yes.

Q Mr. Dorsett, I show you a copy of Plaintiff's Exhibit 75 and ask if you ever have seen that before?

A Yes, I have.

Q Do you recall reading it at the time?

A Yes, I do.

MR. SCHREIBER: May I hand a copy to the court?

Q Do you recall what relevant facts you considered concerning this matter of recapture of brokerage commissions?

THE COURT: I think I have a copy of this. Is this the opinion letter?

MR. SCHREIBER: The Sullivan & Cromwell opinion letter.

Q Can I ask what notes you are reading from?

A The Sullivan & Cromwell note.

Q Now, do you remember what facts you considered? Do you have a copy of the opinion before you?

A Yes, I do.

Q Is that the Sullivan & Cromwell opinion that you have before you?

A Yes.

Q Turn to page 2 of that opinion, sir, the paragraph that begins on page 2 that says, "On the basis of the above and assuming that the board of directors has considered all the relevant facts concerning this matter." Can you tell me what relevant facts you considered?

A I believe the relevant facts were that we could possibly use give-ups to reduce the fee. I did not wish M & D to carry on such a practice.

Q You mean give-ups or executing commissions?

A Give-ups or executing commissions, either one.

Q Do you know whether there were give-ups at this time being directed by the fund or by M & D?

A I already said I don't know that.

Q What other factors did you consider as relevant?

A That is about it, I believe, with regard to this.

Q With regard to the phrase, "All the relevant facts concerning this matter," as appears on lines 2 and 3 of the first paragraph on page 2 of Exhibit 75?

A I believe it was just a matter we were asking an opinion from counsel at that point and I am not sure requested it, for an opinion as to whether or not we had to use the give-up method or if we had to direct our own brokerage, but I believe this matter was primarily talking about the give-up, as to whether we should force the people to give up commissions back to M & D or F. Eberstadt & Company and then reduce the management fee. I believe that was the only thing thatwe were really trying to focus on in this situation. To me that was not a good practice and, therefore, I didn't give it much more consideration than that. Yes, we got out information from them, but, no, I would not care to have M & D carry on that kind of a practice.

Q That is all the consideration you gave it?

A That is right.

Q And all the relevant facts you considered?

A We talked about many other relevant factors. That was my analysis of what was said here, and I still stand, we should not be taking -- well, we can't have a give-up now,

as you know. But I didn't think we should do our own busines which we could do.

Q That is, you still don't feel that the fund should direct brokerage business to Eberstadt for the purposes of recapture and reduction of the advisory fee?

A That and plus I don't feel we should get -- what is the other expression you used earlier -- about a non-membership rebate or something.

Q Non-membership rebate. It's close enough or reasonably close.

Mr. Dorsett, I show you Plaintiff's Exhibit 76, and my question to you is whether it was you or Professor Murray who prepared the first draft of that report?

A I told you before it is in our testimony, and, therefore, if I got to repeat the testimony to save you time of coming back and repeating it to me, I will do it, and that was, I don't know whether I did it or he did it, and if he did it, I reviewed it, and if I did it, he reviewed it. It was back in '67.

Q If you did it, you did it on your own?

A I did it on my own and he added many pages.

Q But no one drafted it for you?

A No. I know he did it one year and I did it another year. when we were serving on the committee together. I don't

know if that is the one I did or the next one.

Q I would like to hand you the exhibit so I can ask you about particular sentences in it. Would you be good enough to hold this before you.

At page 2 there appears the second full paragraph beginning with the words, "We are not so favorably impressed with the distribution of fund shares, although the performance has been adequate and sustaining the fund's investible funds. The losses sustained in distributing shares are, we think, appropriate incentive of a different kind to encourage the devising of a more efficient and effective effort. We believe that such losses are a proper offset to the profits derived from the management function."

Is that still your belief today?

A Yes.

Q And it was at the time?

A I think it has been throughout the history of the fund, but I'm not positive on that score..

Q At page 3, sir, there is reference to Release Number 8239, dated January 26, 1969, of the SEC.

Did you ever read that release?

A I don't know whether I did or not.

Q How did you get the information that is contained in this report which you signed?

A There could have been a short report on it or something like that.

Q From whom?

A I don't know.

Q In other words, you don't know where you got the information?

A No.

Q Go to the next paragraph.

A Did I say I may or may not have read it?

Q Well, you correct it. Say it any way you like.

A Okay. That's the way I would like to have it.

Q You may or may not have read it? I don't want to force you into any reply. If at any point you want to correct what you have said, don't hesitate.

The third paragraph on page 3 says:

"In 1967, as fully disclosed in the proxy statement, the Fund paid brokerage commissions of

$618,000. Of this amount, $510,000 was allocated to dealers based on the volume of Fund shares sold. The allocation of brokerage business and the use of directed give-ups can be regarded as additional compensation to dealers to sell Fund shares."

Now, I am directing my query specifically to the third sentence, beginning, "The allocation."

Where did you get that information?

A We knew that was their practice, generally giving out commission business for -- and I believe this information was in the proxy material. I think it was either in the proxy or the -- what's the other thing that we sent out? The prospectus. This must have been in the proxy material that we sent out, indicating -- no. It had to be in the prospectus. They so allocated their total commission indicating that this was their allocation for -- well, they only say in here for those who sell funds, but I've got to believe there was also a certain amount of research derived from these brokerage firms that they were also given consideration for.

Q That applies to allocation of brokerage business; is that right, sir?

A Right.

Q That is where you got that information?

A Right.

Q And then it continues, "and the use of directed give-ups."

Where did you get that information?

A I don't know, but I believe that was kind of a steady practice in the mutual fund business at that point.

Q Was it a steady practice -- I am sorry.

A I don't know whether we used it. All I am saying is, this was picked out of the proxy. Now, whether they did actually use the give-ups, because to me most of the business was given directly to a broker to execute your business, and that broker was also one of our key sales accounts.

Q Do you now understand that there were directed give-ups used by the Fund at that time?

A I don't know whether there was or not, even though it says there were.

Q I see.

A I don't know that there were.

Q Well, where did you get the information about the use of directed give-ups?

A Probably in the same proxy material.

Q A proxy sent to the shareholders of the Fund?

A Yes.

MR. SCHREIBER: Can I have the 1967 and 1968 proxies?

Q I show you Exhibits 30 and 31, which are the proxy statements of the Fund for the years 1967 and 1968.

Will you show me where there is any reference to directed give-ups in either of those proxy statements?

MR. SCHWARTZ: What number?

MR. SCHREIBER: 30 and 31.

A I don't see it in here, so it's probably in the --

Q In the prospectus?

A In the prospectus.

Q I will show you Exhibits 13 and 14, which are the prospectuses of the Fund for the years 1972 and 1973, and ask if you can find anything there about directed give-ups.

A No. It only has the one reference to Paine, Webber & Jackson, because of him being on the board of the Chemical Fund. Anyway, I know it was in some literature. Would you care to direct me to it rather than play this game?

Q I am not playing a game with you, sir. I don't know of any other literature sent to the shareholders other than the prospectus and the proxy statement.

But as a director of the Fund these many years, you are probably more aware of what you sent to your shareholders than I am, who came at this late date, so you can help me.

MR. SCHWARTZ: May I ask that that remark be stricken?

MR. SCHREIBER: Your Honor, may I submit that that was provoked by the witness' remark that I am playing a game with him.

THE WITNESS: Yes, because we did have the material before for you.

THE COURT: I think, Mr. Schreiber, the witness has indicated very clearly and conclusively what his position was, and I don't think we are getting anywhere on this point.

MR. SCHREIBER: Well, I was only asking the witness for the basis of a report which he says he wrote and which certainly he signed.

THE WITNESS: Yes. I did sign that report.

Q And did you participate in its writing?

A Yes. So it's conceivable that M. & D. furnished us this material. This was the audit committee's report, and we get a lot of material from M. & D. in making that audit and these reports.

Q And M. & D. gives you a lot of material which

you use in preparing this kind of report?

A That's right.

Q So you may have very well used M. & D.'s supplied material to prepare the report which is here, 76?

A That's right.

Q Which you have before you?

A That's right.

Q Thank you, Mr. Dorsett. May I take those out of your way?

MR. SCHREIBER: Your Honor, rather than protract this, we will refer to this exhibit in detail in our brief.

THE COURT: All right.

Q Now, Mr. Dorsett, do you recall reading the decision in that case, Moses versus Bergen?

A The '71 case?

Q That's correct, sir.

A Yes.

Q Do you recall how it came about that that decision came to your attention?

A No. I don't remember now.

Q Just so that we know what we are talking about, I show you --

MR. SCHREIBER: We are just getting this together, your Honor.

Q (Continuing) I show you Plaintiff's Exhibit 90, which is an excerpt from the opinion of the Court in Moses versus Bergen, and I ask you if you recall seeing that portion of the opinion.

A I am quite sure that I have seen it before.

Q You are not quite sure?

A I say, I am quite sure that I have seen it before.

Q I am sorry, sir.

Do you recall discussing that portion of the opinion with the other directors?

A Yes; I do recall discussing it.

Q Do you recall specifically discussing that aspect of the opinion which said that the directors have no choice, as referred to there?

A Yes.

Q Do you recall what your understanding of "no choice" was at the time?

MR. SCHWARTZ: Are you asking this witness what his understanding of Judge Aldrich's opinion was?

MR. SCHREIBER: Yes. He was one of the directors.

MR. SCHWARTZ: I object. You can ask what was said.

THE COURT: Objection sustained.

Q What was said about that "no choice" aspect of the opinion?

A We felt we did have a choice.

Q A choice about what, sir?

A About handling the brokerage business in the fashion that we wanted to.

Q Allocating it as you chose?

A Right.

Q And that is what it meant to you at the time?

MR. SCHWARTZ: I object to that question, your Honor.

THE COURT: The objection is sustained.

Q Was it your opinion that at the time the directors had a choice as to how to handle allocation of execution of portfolio transactions?

A Yes.

Q Was it your opinion that any amendment of the charter or certificate of incorporation of the Fund was necessary to assure that choice?

A I don't know whether we looked at it in that fashion, now, that we would have to go through a charter change or anything like that. Actually, we indicated how we were doing our business, and we so dis-

closed.

Q Do you know --

A We felt that was sufficient.

Q Sorry. I didn't mean to interrupt you. Have you finished your answer?

A Yes.

Q Do you know whether in fact there was any such charter change?

A I don't know.

Q Do you attend the annual meetings?

A No.

Q That is, the annual meetings of the shareholders of the Fund?

A No.

Q You do not?

A It was usually done in Delaware, until about three years ago, I think, something like that.

Q And since then where has it been held?

A Well, I am not sure of when they changed. It was either two years ago, or maybe it was three years ago. It's been held now in the New York office.

Q In the New York office.

Do you attend the shareholders' meetings held in the New York office?

A No.

Q Where is your office?

A At -- between 44th and 45th on Third Avenue.

Q Where is the shareholders' meeting?

A 61 Broadway. I also happen to have a conflict with this particular meeting.

Q I show you Plaintiff's Exhibit 14, which is the April 29, 1968 prospectus.

By the way, do you see these prospectuses in draft before they are finalized?

A Yes.

Q Each year?

A Yes.

Q Did you see Exhibit 14 in draft before it was finalized?

A Yes.

Q And you saw it in final form, of course, too?

A Pardon?

Q You saw it in the final shape?

A Yes.

Q There is reference in 14, which you have before you, at the page to which I opened it, to the fact that $61,000 was paid --

MR. SCHWARTZ: What page, Mr. Schreiber?

MR. SCHREIBER: I am sorry. I left my copy with the witness.

I will get the copy, and I will just give Mr. Schwartz the page number.

It is page 8.

Q (Continuing) There is reference to the fact that $61,000 of brokerage commissions, representing approximate value, was allocated to dealers who provided statistical and research information to the management. And it continues.

The management has informed the Fund that these services do not reduce the expense of the manager by a material amount.

Do you know how that $61,000 was arrived at?

A No.

MR. SCHREIBER: In order to save time, your Honor, if I may read from the deposition -- and I am almost through, your Honor --

THE WITNESS: I would like to say that this is the material that we got this earlier statement from.

Q About give-ups?

A I don't know about the give-ups, but this all indicates where the total commission s are and how much was going towards the dealer based on volume of shares

sold.

Q My question to you before was where you got the information about directed give-ups, which was the precise phrase.

Is there anything in Exhibit 1' --

A No.

Q -- which contains that?

A No.

MR. SCHREIBER: Now, if I may read to the Court, your Honor --

MR. SCHWARTZ: What page?

MR. SCHREIBER: Starting at page 333.

MR. SCHWARTZ: What line?

MR. SCHREIBER: Starting at line 17.

THE COURT: Is this for my benefit or part of the examination of the witness? The reason I am asking is that I want to find out how long it is.

MR. SCHREIBER: It is quite long, your Honor. Instead of reading it, if I may hand up the transcript and mark it in evidence, I will be quite content.

THE COURT: Either way. If you want to protect the record, to be sure -- I would suggest that you can have the reporter mark the page and make it a part of this record, or you can file it as an exhibit, whichever

you want. I don't see any necessity for it to be read.

MR. SCHREIBER: I think it will take me no more than three or four minutes to read it into the record, your Honor. It might be just as quick, and then I will sit down.

MR. SCHWARTZ: I have no objection to putting it all in evidence, if Mr. Schreiber wants it.

THE COURT: Mr. Schreiber may not want all of it in evidence.

MR. SCHWARTZ: I am aware of that, your Honor.

THE COURT: Of course, you can read in anything you want.

MR. SCHREIBER: Your Honor, I offer the transcript of Mr. Dorsett's deposition of September 11th as an exhibit.

(Plaintiff's Exhibit 163 was received in evidence.)

xx THE COURT: Is there any particular portion of this to which you want to call my attention?

MR. SCHREIBER: Yes, your Honor. I want to call your attention to pages 333 through 335, and I will not read them into the record.

I have no further questions of this witness.

MR. SCHWARTZ: May I impose on your Honor for

a few brief questions?

CROSS EXAMINATION

BY MR. SCHWARTZ:

Q Mr. Dorsett, what was the size of the equity portfolio you managed at the University of Rochester?

A When I went there, I guess it was about $120 million. When I left, some eight years later, I believe it was somewhere between $350 million and $400 million.

Q Is that because of sales or contributions or performance?

A Performance.

Q How big is the equity portfolio you now manage at College Retirement Equity Fund?

A About $2 billion.

Q What proportion of that is common stock?

A Well, we've got to be 95 per cent in common stock at all times, as a matter of policy.

Q At the University of Rochester, what was your responsibility for execution of portfolio transactions?

A I handled a good many of the executions, at least half of them.

Q Did you have any supervisory responsibility for the others?

A Some, yes.

Q What is your responsibility at CREF for portfolio executions?

A Well, I oversee my head trader, who has to oversee his three assistants.

Q Does the head trader report to you?

A Yes.

MR. SCHWARTZ: I have no further questions.

MR. SCHREIBER: Your Honor, I have no further questions of this witness. He may stand down.

THE COURT: All right, Mr. Dorsett.

Thank you.

(Witness excused.)

MR. SCHREIBER: We have no further rebuttal witnesses, your Honor.

As you may recall, at the time of the preparation and consultation with the Court regarding the preparation of the pretrial order, I indicated to the Court that we were prepared to push ahead on the issue of liability.

As to the issue of damages, assuming liability, we were only partially prepared. We stand in that same situation today, your Honor. Should liability be determined, we would ask for, as prayed for in the prayer for relief in the complaint, an accounting be directed, at

which time the amount of damages wo uld be developed more fully.

With this, we rest.

THE COURT: All right.

I am agreeable to that procedure, Mr. Schwartz.

MR. SCHWARTZ: Your Honor, --

THE COURT: Did you hear what Mr. Schreiber said?

MR. SCHWARTZ: I heard what he said. I think I have expressed before my disagreement with what he says. I believe that the issues of liability and damages are interrelated, and I think it was Mr. Schreiber's burden to show the dollars, but that is your Honor's decision. If you want to decide just liability, there is not much I can do about it.

THE COURT: Well, I think that at this phase of the proceedings, in any event, with the record as it stands now -- and I think that whether liability has been established, that the Fund should have operated as the plaintiff contends they should have operated -- and if I do find they should have operated in that fashion, then the question, it seems to me, is whether In fact the shareholders have been damaged, and it may well be that they may not have been damaged. So it may be an abstract

question.

It seems to me that the three of us are not too far apart. I think that is the better way to proceed, because if I find that the defendants were correct, that the matter was one of business judgment, obviously I will have to dismiss the action, and the Court of Appeals will determine whether I am right or wrong.

I think we will proceed in this way.

Now, I gather that you would want, Mr. Schreiber, to file a post-trial brief.

MR. SCHREIBER: I think it would be helfpful to the Court.

THE COURT: It certainly would be. Since daily copy has been afforded, there is no question about waiting for the transcript.

MR. SCHREIBER: Your Honor, I have not had the benefit of the daily copy that was ordered by Mr. Schwartz, but I imagine a copy will be available rather quickly, in any event.

I would like to suggest -- and I have discussed this with Mr. Schwartz -- subject to your Honor's approval that plaintiffs submit a brief and defendants answer, and then plaintiffs have an opportunity for reply.

In discussion with Mr. Schwartz, it was

suggested that we have six weeks after the receipt of the transcript for plaintiff's brief and that Mr. Schwartz have forty days after service of plaintiff's brief with in which to serve the defendants' brief and that we have two weeks thereafter to reply.

This, of course, is subject to your Honor's ruling.

THE COURT: I will tell you, after you have submitted a pretrial order, it doesn't appear to me that this time schedule is the most efficient one. My usual practice is to have both sides submit their briefs simultaneously, because what I want is the brief to be geared to the evidence.

I have your legal theories, which have been outlined, and it seems to me what I now want, what would be most helpful to you is for you to illuminate that theory with what is in the record.

So I would want a post-trial memorandum from both sides, geared to the testimony that has been adduced.

MR. SCHREIBER: And to the exhibits, of course.

THE COURT: Well, that is part of the record.

MR. SCHREIBER: That is rather a heavy burden

but one which we must face.

THE COURT: Well, I am facing a heavy burden also, but, Mr. Schreiber, you brought the case and burdened us all with it.

MR. SCHWARTZ: I don't think you will read more than 20 per cent of the exhibits, your Hnor.

THE COURT: Whatever the time schedule is, I will be agreeable to you and Mr. Schwartz submitting a brief, and then I will give both of you time thereafter, if there is anything that you feel you need to answer, to file a reply.

MR. SCHREIBER: Simultaneously?

THE COURT: Everything simultaneous.

MR. SCHWARTZ: February 18th for both briefs?

MR. SCHREIBER: That is agreeable to me.

THE COURT: All right.

And I will give you two weeks after that, if you care to reply.

Now, you have 162 exhibits, and I suggest what you do is have them copied for me, and when you file your reply, then you can turn them over.

MR. SCHREIBER: I was about to request that privilege of the court.

THE COURT: I don't have any of your exhibits.

MR. SCHREIBER: No, sir. We have a complete roster.

MR. SCHWARTZ: Does your Honor want proposed findings of fact revised?

THE COURT: Yes. I am glad you mentioned it. I want proposed findings of fact.

MR. SCHWARTZ: With citations.

THE COURT: And conclusions of law.

It may be that you will not want to supplement them, because of the fact that you have covered this. I am going to read this, and I want you to give me some help on the testimony.

If you want to revise your post-trial findings and conclusions based on what has been adduced in the evidence, that is up to you.

MR. SCHWARTZ: There will have to be citations to the record; otherwise your Honor will have great difficulty in finding things.

THE COURT: Is there anything else, gentlemen?

MR. SCHREIBER: Thank you, your Honor.

MR. SCHWARTZ: Thank you, your Honor.

WITNESS INDEX

Name	Direct	Cross	Redirect	Recross
Burt Dorsett	227	283		

EXHIBIT INDEX

Plaintiff	Identification	In Evidence
162	239	
163		282

PLAINTIFF'S EXHIBIT 35.

CHEMICAL FUND, INC

Deft. Exh. For ID 94
Plf. Exh. In EV
Walter Shapiro CSR
Doyle Reporting Inc.
8-29-74

NOTICE OF ANNUAL MEETING

To Shareowners of CHEMICAL FUND, INC.:

Notice is hereby given that, pursuant to the By-Laws, the annual meeting of the shareowners of Chemical Fund, Inc., a Delaware corporation, will be held at the office of the Fund, 61 Broadway, New York, New York 10006, on Tuesday, March 14, 1972, at 11:00 a.m., for the following purposes:

(1) To amend the By-Laws of the Fund so as to increase the maximum number of directors to fifteen and to fix the number of directors at fifteen;

(2) To elect fifteen directors of the Fund;

(3) To ratify or reject the selection by the Board of Directors of Price Waterhouse & Co. as independent accountants for the Fund;

(4) To act upon a proposal recommended by the Board of Directors to amend the Amended Certificate of Incorporation of the Fund so as to increase the authorized capital stock from 35,000,000 shares to 100,000,000 shares and to change the par value thereof from $.25 per share to $.12½ per share, thereby effecting a 2 for 1 stock split of each outstanding share of capital stock of the Fund;

(5) To act upon a proposal recommended by the Board of Directors to amend the Amended Certificate of Incorporation of the Fund to clarify provisions thereof as to the powers of the Board of Directors in the allocation of portfolio brokerage for the Fund;

(6) To approve or disapprove a new Management Agreement; and

(7) To transact such other business as may properly come before the meeting or any adjournments thereof.

The Board of Directors has fixed the close of business on January 24, 1972 as the record date for determination of the shareowners entitled to notice of, and to vote at, the meeting.

By order of the Board of Directors,

January 27, 1972

MARY A. BARRY, *Secretary*

Shareowners who do not expect to attend in person are requested to fill in, date, sign and return the proxy card in the enclosed envelope, which requires no postage if mailed in the United States.

PLAINTIFF'S EXHIBIT 35

PROXY STATEMENT

CHEMICAL FUND, INC.

Accompanying this statement is a Notice of Annual Meeting of Shareowners. Also enclosed is a form of Proxy for such meeting solicited by the management of the Fund and an Annual Report containing financial statements for the year ended December 31, 1971.

The Proxy may be revoked at any time before it is exercised and any shareowner attending the meeting may vote in person whether or not he has previously filed a proxy. The shares represented by all properly executed proxies received in time for the meeting will be voted. The cost of soliciting proxies will be borne by the Fund. In addition to the solicitation of proxies by use of the mails, it is possible that proxies may be solicited personally by regular employees of the Fund or its Manager by telephone. In such event such employees will receive no additional remuneration therefor. The additional cost of any such solicitation will be borne by the Manager.

The Fund has only one class of Capital Stock and each of the 34,119,161 shares outstanding on the record date, January 24, 1972, will be entitled to one vote. A quorum for the meeting shall consist of one-third of the shares outstanding. The affirmative vote of a majority of the outstanding shares entitled to vote will be required for action on Purposes 4 and 5, of a majority of such outstanding shares as defined in the Investment Company Act of 1940 (either (i) 67% or more of the voting securities present at such meeting if the holders of more than 50% of the outstanding voting securities are present or (ii) more than 50% of the outstanding voting securities, whichever is less) for Purpose 6 and of a majority of the shares represented at the meeting with respect to Purposes 1, 2 and 3.

The enclosed Proxy contains spaces in which you may insert instructions as to the way your shares are to be voted on Purposes 1, 2, 3, 4, 5 and 6. Where a shareowner has specified a choice on his proxy with respect to any of such Purposes, his shares will be voted accordingly. In the absence of a specified choice, shares will be voted in favor of such Purposes.

In order that your shares may be represented at the meeting, or any adjournment thereof, you are requested to:

- indicate your instructions on the Proxy
- date and sign the Proxy
- mail the Proxy promptly in the enclosed envelope, which requires no postage if mailed in the United States
- allow sufficient time for the Proxy to be received at or before 11:00 A.M. on March 14, 1972.

BY-LAWS AMENDMENT & DIRECTORS
(Purposes 1 and 2)

The By-Laws of the Fund provide that a maximum of 14 directors shall be elected annually and hold office until their respective successors are elected and qualify.

It is proposed to vote the proxy in favor of amending the By-Laws of the Fund so as to increase the maximum number of directors from 14 to 15 in order to permit the election of Mr. John F. Van Deventer as a director. Mr. Van Deventer joined the firm of F. Eberstadt & Co. in 1951. He has been Senior Vice President of Chemical Fund, Inc. since 1963 and Vice President of The Eberstadt

PLAINTIFF'S EXHIBIT 35

Fund, Inc. since 1966. He is also a Vice President and Director of F. Eberstadt & Co., Inc. and F. Eberstadt & Co., Managers & Distributors, Inc. He is a graduate of Hamilton College and Columbia University Graduate School of Business Administration from which he received a B.A. and an M.S., respectively.

It is proposed to vote the proxy for the election, as directors, of the 14 persons who are currently directors of the Fund and for the election, if the By-Laws Amendment is approved, of John F. Van Deventer. Information as to the fifteen nominees is given in the tabulation below. None of the designated nominees is expected to decline or become unavailable for election. However, should this occur, the proxy confers discretionary power to vote in favor of a substitute nominee or nominees.

Name and Principal Occupation	Nature of Business	Position Held in Chemical Fund, Inc.	Director Since	Shares of Fund Owned Beneficially Dec. 31, 1971
Dr. James S. Coles, President, Research Corporation since January 1, 1968; President of Bowdoin College from 1952 to December 31, 1967	Foundation for Advancement of Science	Director	1968	123
Burt N. Dorsett, Executive Vice President, College Retirement Equities Fund; formerly Vice President for Investments, University of Rochester	Investments	Director	1966	265
Alfred E. Driscoll, Consultant, Warner-Lambert Company; Chairman, New Jersey Turnpike Authority, formerly Honorary Chairman of the Board, Warner-Lambert Company	Transportation	Director	1957	1,668
*Andrew W. Eberstadt, Vice President, F. Eberstadt & Co., Inc.	Investment Banking	Vice President & Director	1962	381
Dr. Bertrand Fox, Jacob H. Schiff Professor of Investment Banking and until July 1968 Edsel Bryant Ford Professor of Business Administration and Director of Research, Harvard University Graduate School of Business Administration	Educator	Director	1970	106
Whitman Hobbs, Advertising and Marketing Consultant; formerly Senior Vice President, Benton & Bowles, Inc.	Advertising	Director	1962	1,166
Leroy F. Marek, retired, former Senior Vice President, Arthur D. Little, Inc.	Industrial Research Consultants	Director	1959	767
Dr. Roger F. Murray, S. Sloan Colt Professor of Banking and Finance, Graduate School of Business, Columbia University; formerly Executive Vice President and Economist, College Retirement Equities Fund and Teachers Insurance and Annuity Association	Educator	Director	1959	1,417

PLAINTIFF'S EXHIBIT 35

Name and Principal Occupation	Nature of Business	Position Held in Chemical Fund, Inc.	Director Since	Shares of Fund Owned Beneficially Dec. 31, 1971
*Robert C. Porter, President, F. Eberstadt & Co., Inc.	Investment Banking	President & Director	1965	1,781
Auguste Richard, Trustee	Trustee for Individuals	Director	(1938-42) 1954	5,000
Dr. Howard A. Rusk, Director, Institute of Rehabilitation Medicine, New York University Medical Center	Physician	Director	1962	5,455
F. Schneider, Financier	Corporate Director and Consultant	Director	1938	270
*John F. Van Deventer, Vice President, F. Eberstadt & Co., Inc.	Investment Banking	Senior Vice President	—	816
*Francis S. Williams, Vice Chairman of the Board, F. Eberstadt & Co., Inc.	Investment Banking	Chairman & Director	1952	2,884
*Robert G. Zeller, Chairman of the Board, F. Eberstadt & Co., Inc.	Investment Banking	Vice Chairman & Director	1964	307

* A Partner of F. Eberstadt & Co. immediately prior to its incorporation on October 31, 1969.

Directors not affiliated with the Manager and Distributor each receive from the Fund fees of $3,000 annually. Directors who are members of the Portfiolio Committee and not affiliated with the Manager and Distributor receive from the Fund additional annual fees of $7,500 to the director acting as Chairman and $5,000 each to other members.

No compensation is paid to the directors, officers or members of the Portfolio Committee of the Fund associated with F. Eberstadt & Co., Inc. or its wholly-owned subsidiary, F. Eberstadt & Co., Managers & Distributors, Inc. All of the officers of the Fund are associated with F. Eberstadt & Co., Managers & Distributors, Inc. which is the Fund's Manager and Distributor. The Chairman or the Vice-Chairman and the President of the Fund serve on the Portfolio Committee, in addition to three non-affiliated directors.

SELECTION OF INDEPENDENT ACCOUNTANTS

(Purpose 3)

Price Waterhouse & Co., 60 Broad Street, New York, N. Y. 10004, have acted as independent accountants for the Fund since its inception. Pursuant to the Investment Company Act of 1940, a majority of those members of the Board of Directors who are not interested persons of the Fund have selected Price Waterhouse & Co. to continue as accountants for the Fund with respect to its fiscal year ending December 31, 1972, and recommended that such selection be ratified. Neither the firm nor any of its members has any direct or indirect financial interest in or any connection with the Fund in any capacity other than as auditors.

PLAINTIFF'S EXHIBIT 35

AMENDMENT OF CERTIFICATE OF INCORPORATION
(Purpose 4)

Net sales of the Fund's shares have increased at a substantial rate in each of the last two years with 3,490,396 shares having been issued in 1970 and 3,994,529 shares in 1971 so that as of January 24, 1972 there were 34,119,161 shares issued and outstanding compared with authorized capital stock of 35 million shares. It will therefore be necessary to increase the authorized capital stock in order to provide additional authorized shares for continuing sales, which is a desirable feature of an open-end mutual fund. In addition, an increase in the authorized shares will be necessary to permit the payment of the capital gains distribution in shares which the Board of Directors declared on January 19, 1972. In connection with the increase in the authorized capital stock, the Board of Directors has determined it would be advisable to split the common stock 2 for 1 and reduce the par value of the outstanding capital stock from $.25 to $.12½ per share. The Board of Directors believes that the lower offering price resulting from the proposed stock split should enhance the marketability of the shares of the Fund by making them attractive to a larger number of investors. If the proposed stock split is approved, the shareowners of record at the close of business March 17, 1972 will receive one additional share for each share held on that date, including any shares received from the capital gains distribution paid on the same date. The additional shares will be credited by Bradford Mutual Fund Services, Inc., the Shareholder Servicing Agent for the Fund, to the shareowner's account and no stock certificates will be issued unless Bradford receives a written request from the shareholders requesting the same. It will not be necessary for a shareowner who now holds stock certificates to send them in for exchange. The par value of each share represented by such certificate now held will be $.12½ per share rather than $.25 per share, effective March 17, 1972.

Accordingly, the Board of Directors has declared it advisable and recommends to shareowners their favorable action on an amendment to Article Fourth of the Amended Certificate of Incorporation of the Fund so as to increase the authorized capital stock from 35,000,000 to 100,000,000 shares and to change the par value thereof from $.25 per share to $.12½ per share, thereby effecting a 2 for 1 stock split. This amendment will not affect any of the rights of the capital stock.

AMENDMENT OF CERTIFICATE OF INCORPORATION
(Purpose 5)

In order to make explicit the powers of the Board of Directors with respect to portfolio brokerage of the Fund, it is proposed to make the following amendment to the Amended Certificate of Incorporation:

Amend Section B of Article Eighth of the Amended Certificate of Incorporation by the addition of a new subdivision 8 as set forth below:

> B. The Board of Directors shall have the entire management and control of the property, business and affairs of the Corporation, and is hereby vested with all the powers possessed by the Corporation itself so far as this delegation of authority is not inconsistent with law or this Certificate of Incorporation. In furtherance and without limitation of the foregoing provisions, it is expressly declared that, subject to this Certificate of Incorporation, the Board of Directors shall have power:
>
> .....
>
> 8. To determine in their discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund and the selection of the brokers and

dealers that shall receive or share directly or indirectly in any such commissions and the basis of such receiving or sharing therein, including, but not limited to, sales of shares of the Fund and any other funds having the same investment adviser and statistical and other information and wire and other services provided to the Fund or the Manager.

The purpose of the above amendment is to make explicit that which has always been implicit, namely, that the Board of Directors of the Fund (more than 50% of whom are otherwise unaffiliated with the Fund or its Manager) has the power to determine how the portfolio brokerage of the Fund shall be used. In the opinion of the Board of Directors of the Fund, it is in the best interest of the Fund to continue the brokerage practices which it has followed since inception under which all portfolio transactions have been carried out by brokers who are not affiliated with the Manager and Distributor of the Fund and not to make any provision for recapture through an affiliated broker of any part of the brokerage commissions paid by the Fund.

Accordingly, as reflected in the proposed new Management Agreement discussed below, the Board of Directors has directed the Manager not to have the Fund purchase or sell any portfolio securities through the firm of F. Eberstadt & Co., Inc., the parent of the Manager, which is a member of the New York and American Stock Exchanges. As indicated under "Allocation of Portfolio Brokerage and Portfolio Turnover Rate" below in this proxy statement, the Fund's Board of Directors and the Manager consider that, subject to obtaining the best price, execution and commission, allocation of brokerage to dealers who have sold shares of the Fund or have provided statistical and research information has been and presently continues to be of benefit to the Fund and its shareholders. The Fund's Manager has been authorized by the Board of Directors to select in the Manager's discretion the brokers or dealers that shall execute portfolio transactions or share directly or indirectly in commissions with respect thereto, and to determine the basis of such sharing, subject in each case to obtaining the best execution taking into consideration, among other things, price (including any brokerage commission), size of the transaction and need for speed in execution. The Board, of course, would have the right to determine in the future that some other course of action might be desirable.

MANAGEMENT AGREEMENT

(Purpose 6)

The proposed new Management Agreement, to become effective March 14, 1972, is set forth hereinafter as Exhibit A and was approved by a majority of the directors who are not parties to such Agreement or interested persons of either such party at a meeting on January 19, 1972. It is identical with the existing Management Agreement except as indicated in Exhibit A. In addition to certain minor technical changes which are necessary to meet the requirements of the Investment Company Amendments Act of 1970 (as indicated in the Note on page A-4 of the attached Exhibit A), the only other change as indicated on page A-1 of Exhibit A relates to allocation of portfolio brokerage as stated above under "Amendment of Certificate of Incorporation (Purpose 5)."

The Agreement provides that the Manager shall furnish the Fund with investment advice and, subject to the Fund's Board of Directors, shall manage and supervise its business and affairs; shall furnish the Fund with all statistical information reasonably required by the Fund and reasonably available to the Manager; shall furnish the Fund with an office and with clerical and bookkeeping services at such office; and shall permit any of its officers, directors, and employees to serve, without compensation, in the capacities to which they have been elected.

PLAINTIFF'S EXHIBIT 35

The management fees payable to the Manager shall be the same as provided in the present Management Agreement. The fee is computed in accordance with the table below depending on whether the investment results of the Fund are better or worse than those of the Standard & Poor's Index of 425 Industrial Stocks over periods of the preceding 36 months computed at the end of each calendar quarter at one quarter of the annual rates indicated. The applicable "percentage points", rounded to the nearest hundredth, for any period is determined by algebraically subtracting (a) the percentage increase or decrease in the Index for the three years ending with such period from (b) the percentage increase or decrease in the Fund during the same period measured in terms of net asset value per share after adding back capital gains distributions during the period to the net asset value per shar at the end of the period.

TABLE OF FEES FOR RELATIVE RESULTS

Chemical Fund's Results Relative to S & P 425 Industrial Index In Percentage Points	First $1 Billion of Assets — Applicable Annual Rate	Next $500 Million of Assets — Applicable Annual Rate	Assets in Excess of $1½ Billion — Applicable Annual Rate
+ 10.01 or better	.40%	.35%	.30%
+ 7.51 to + 10.00	.39	.34	.29
+ 5.01 to + 7.50	.38	.33	.28
+ 3.01 to + 5.00	.37	.32	.27
+ 1.01 to + 3.00	.36	.31	.26
+ 1.00 to — 1.00	.35 *(basic)*	.30	.25
— 1.01 to — 3.00	.34	.29	.24
— 3.01 to — 5.00	.33	.28	.23
— 5.01 to — 7.50	.32	.27	.22
— 7.51 to — 10.00	.31	.26	.21
— 10.01 or poorer	.30	.25	.20

Note: When the average net assets exceed $1 billion, the fee will be computed separately on the first $1 billion and on the assets in excess of $1 billion in accordance with the table above. The results of the separate calculations will be added to obtain the aggregate fee.

The proposed Management Agreement may be continued in effect from year to year provided that such continuance is approved, either (a) by the vote of the Board of Directors, or (b) by a vote of a majority (as defined in the Investment Company Act of 1940) of the outstanding shares of the Fund. In either case the vote of a majority of the directors who are not interested persons of any party to the Agreement cast in person at a meeting called for the purpose of voting on such approval will be required. It will terminate unless so approved annually by the directors or shareowners of the Fund, and may be terminated without penalty on 60 days' written notice by directors or by the owners of a majority of the shares of the Fund or by the Manager, and will terminate automatically if assigned.

MANAGER AND DISTRIBUTOR

The present Management Agreement is described above. It was submitted to shareowners and approved by them at the annual meeting of shareowners held on May 14, 1971. Such approval was required because of certain amendments to the Management Agreement which were then made. The

present Management Agreement provides for payment quarterly to the Manager of compensation at the annual rates shown above. The management fee for the year ended December 31, 1971 amounted to $2,247,468. Of this amount $1,881,935 represented the basic fee and $365,533 represented the additional performance fee.

F. Eberstadt & Co., Managers & Distributors, Inc. also acts as the investment adviser for The Eberstadt Fund, Inc., an open-end investment company with assets of approximately $44,000,000 at December 31, 1971. The management fee payable to the Manager from The Eberstadt Fund is at the annual rate of .50% on assets up to $75,000,000 and is scaled downward on larger amounts. The management fee paid by The Eberstadt Fund to the Manager for calendar year 1971 was $215,655.

The Manager and Distributor also acts as exclusive agent of the Fund in the sale of its shares. The Distribution Agreement provides that it will terminate unless approved annually by the Board of Directors or shareowners of the Fund and will be terminated automatically in the event of its assignment. For the fiscal year ended December 31, 1971, net selling commissions received by the Distributor amounted to $732,232, after $2,433,832, was reallowed to non-affiliated dealers.

CERTAIN TRANSACTIONS BETWEEN F. EBERSTADT & CO., INC. AND THE ESTATE OF MR. FERDINAND EBERSTADT

The Fund has been advised by F. Eberstadt & Co., Inc. (the "Eberstadt firm"), the parent of the Fund's Manager, F. Eberstadt & Co., Managers & Distributors, Inc. ("M & D"), of the following transactions pursuant to an agreement between the Eberstadt firm and the estate of the late Mr. Ferdinand Eberstadt (the "Eberstadt Estate"):

On September 17, 1971, the Eberstadt firm acquired from the Eberstadt Estate (subject to the judicial determinations and the escrow arrangement referred to below) all of the outstanding 15,000 shares of the Eberstadt firm's 6% Convertible Preferred Stock, par value $100 per share, in exchange for its 10% Subordinated Debenture in the original principal amount of $1,500,000. The Debenture matures December 31, 1974, subject to acceleration under specified circumstances essentially involving the sale of substantially all of the stock or assets of either M & D or the Eberstadt firm. If, upon maturity of the Debenture, 51% of the then fair market value of the outstanding stock of M & D, after certain adjustments, exceeds $1,500,000, the principal amount of the Debenture will be increased by the amount of such excess.

The holders of more than 50% of the principal amount of the debentures may elect at maturity to apply all or part of the retirement price to the purchase of M & D stock from the Eberstadt firm at its fair market value. If they elect to purchase as much as 50% of said stock, the Eberstadt firm may require them to buy all or any part of the remainder.

The agreement between the Eberstadt firm and the Eberstadt Estate also provides, among other things, that Mr. Frederick Eberstadt, the son of the late Mr. Ferdinand Eberstadt and one of the Executors of the Estate, will be a director of M & D, and that he be recommended by the Eberstadt firm for election as a member of the Board of Directors of Chemical Fund, Inc. and The Eberstadt Fund, Inc. Mr. Frederick Eberstadt has not executed the agreement mentioned above, and the Eberstadt firm understands he intends to oppose its approval in the judicial proceedings referred to below. The Board of Directors of Chemical Fund, Inc. has determined to take no action on the nomination of Mr. Frederick Eberstadt as a director at this time.

PLAINTIFF'S EXHIBIT 35

The purchase of the 6% Convertible Preferred Stock and the other transactions covered by the agreement between the Eberstadt firm and the Eberstadt Estate are subject to the determinations which shall be made in a proceeding now pending in the Surrogate's Court of Suffolk County, New York for a construction of certain provisions of Mr. Ferdinand Eberstadt's will and other matters and to such other judicial determinations as counsel may consider necessary. The parties have agreed to use their best efforts to secure the approval of the agreement, and the transactions therein provided for, in all such proceedings. In the meantime, the documents effecting the purchase of such stock are being held in escrow.

ALLOCATION OF PORTFOLIO BROKERAGE AND PORTFOLIO TURNOVER RATE

Brokers receive commissions at standard rates on portfolio transactions up to $500,000 and at negotiated rates on transactions in excess of this amount since April 1, 1971. For the fiscal year ended December 31, 1971 brokerage fees paid by the Fund on the purchase and sale of the Fund's portfolio securities amounted to $920,767. The Fund has also executed portfolio transactions with dealers acting as principals in the "third market" and directly with institutions in the "fourth market". The Fund does not deal exclusively with any particular broker-dealer or group thereof. The Fund always seeks to place portfolio transactions where it can obtain the best net price which results from the most favorable combination of price, commission and execution and deals directly with a principal market maker in connection with over-the-counter transactions. The Fund's Board of Directors and the Manager consider that, subject to obtaining the best price, execution and commission, allocation of brokerage to brokers who have sold shares of the Fund or have provided statistical and research information is, and presently continues to be, of benefit to the Fund and its shareholders. In many instances the broker who provides the best execution also provides statistical and research information and also may have sold shares of the Fund. To the extent possible, the Manager selects broker-dealers who have provided a broad range of services to the Fund. It is impossible therefore to determine the precise amount of brokerage that was allocated for any single service. Officers of the Manager, who are also officers of the Fund, are responsible for the allocation of brokerage business and placement of brokerage orders, subject at all times to obtaining the best price and execution. The Fund's portfolio turnover rate, exclusive of short-term notes, for the last three fiscal years was 10.3% for 1969, 12.1% for 1970 and 13.2% for 1971.

As indicated above, the Board of Directors has directed the Manager not to have the Fund purchase or sell any portfolio securities through the firm of F. Eberstadt & Co., Inc., the parent of the Manager. The Board, of course, has the right to determine in the future that some other course of action might be desirable.

AFFILIATION OF OFFICERS AND CERTAIN DIRECTORS OF THE FUND WITH THE MANAGER AND DISTRIBUTOR

F. Eberstadt & Co., Inc., 61 Broadway, New York, New York 10006 owns all of the outstanding capital stock of F. Eberstadt & Co., Managers & Distributors, Inc. The three stockholders of F. Eberstadt & Co., Inc. owning 10% or more of its outstanding voting securities are Francis S. Williams, Robert G. Zeller and Robert C. Porter.

As of December 31, 1971, officers and directors of the Fund, of the Manager and Distributor and of F. Eberstadt & Co., Inc. owned of record and beneficially 39,251 shares (representing .12%) of the Fund.

PLAINTIFF'S EXHIBIT 35

The names of the present directors and officers of the Fund who are also directors or officers of F. Eberstadt & Co., Managers & Distributors, Inc. are:

Name	Position with Chemical Fund, Inc.	Position with F. Eberstadt & Co. Managers & Distributors, Inc.
Francis S. Williams	*Chairman of the Board and Director*	*Chairman of the Board and Director*
Robert G. Zeller	*Vice Chairman of the Board and Director*	*Vice Chairman of the Board and Director*
Robert C. Porter	*President and Director*	*President and Director*
Andrew W. Eberstadt ..	*Vice President and Director*	*Vice President and Director*
Robert L. Newton	*Senior Vice President*	*Vice President and Director*
John F. Van Deventer ..	*Senior Vice President*	*Vice President and Director*
N. J. Prestigiacomo ...	*Vice President*	*Vice President and Director*
Wayne D. Leizear	*Vice President*	*Vice President*
Dr. Robert C. Perez	*Vice President*	*Vice President*
James Phillips	*Vice President*	*Vice President*
David H. Dievler	*Treasurer and Assistant Secretary*	*Vice President—Finance and Secretary*
Mary A. Barry	*Secretary*	*Assistant Secretary*
Charles Kim	*Assistant Treasurer and Assistant Secretary*	*Assistant Treasurer*

The principal occupation of the foregoing is with F. Eberstadt & Co., Inc., its wholly-owned subsidiary F. Eberstadt & Co., Managers & Distributors, Inc. or the investment companies managed by the latter (Chemical Fund, Inc. and The Eberstadt Fund, Inc.). The address of each of the foregoing is 61 Broadway, New York, N. Y.

LITIGATION

An action, Kauffman v. Dreyfus Fund, Inc. et al., was brought in 1969 in the U. S. District Court for the District of New Jersey against 141 mutual funds, investment advisers and individual directors and the Investment Company Institute. The Fund, F. Eberstadt & Co. and Francis Williams were included among the named defendants. The complaint sought to recover damages both on behalf of and against the Fund by reason, among other things, of alleged combination to fix management fees at excessive levels in violation of the antitrust laws and to improperly direct brokerage commissions on Fund portfolio transactions. By a decision of the U. S. Court of Appeals for the Third Circuit, the action has been dismissed as against the Fund, except to the extent that it continues to assert a derivative claim under the antitrust laws. As so limited, the action has been transferred to the U. S. District Court for the Southern District of New York in respect of the Fund, F. Eberstadt & Co. and Francis Williams.

An action has been brought in the U. S. District Court for the Southern District of New York by a person who claims to be a shareholder of the Fund. F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers & Distributors, Inc. and the directors of the Fund are named as defendants. The complaint challenged the brokerage practices and the reasonableness of management fees paid by Chemical Fund, Inc. The complaint seeks injunctive relief and damages for the benefit of the Fund.

OTHER ACTION

The management knows of no business which will be presented for action at the meeting other than Purposes 1, 2, 3, 4, 5 and 6 in the Notice of Annual Meeting.

If any other matters do properly come before the meeting, it is intended that the proxy shall be voted in accordance with the judgment of the person or persons exercising at the meeting the authority conferred by the proxy.

PLAINTIFF'S EXHIBIT 35

F. EBERSTADT & CO., MANAGERS & DISTRIBUTORS, INC.

BALANCE SHEET

August 31, 1971

ASSETS			LIABILITIES AND STOCKHOLDER'S EQUITY	
Cash		$1,029,214	Estimated income taxes	$ 147,706
Receivable from dealers and others on sales of Fund shares	$1,155,598		Other accounts payable and accrued liabilities	452,313
				$ 600,019
Less—Payable to Funds upon collection for sales of their shares (Note 1)	1,139,955	15,643	Stockholder's equity:	
			Capital stock $100 par value—2,500 shares authorized and outstanding (Note 3)	250,000
Receivable from Funds including management fees of $418,459		419,510	Retained earnings (Notes 2 and 4)	1,046,702
				1,296,702
Receivable from F. Eberstadt & Co., Inc. (Note 2)		54,661		
Other receivables		18,037	Commitments and contingent liabilities (Notes 4 and 5)	
Furniture, fixtures and leasehold improvements, at cost, less accumulated depreciation and amortization of $148,971		340,227		
Prepaid expenses		19,429		
		$1,896,721		$1,896,721

NOTES TO BALANCE SHEET

August 31, 1971

NOTE 1—F. Eberstadt & Co., Managers & Distributors, Inc. acts as agent for Chemical Fund, Inc. and The Eberstadt Fund, Inc. in the sale of shares of the Funds. In the normal course of business, payment for shares sold is made to the respective Funds by the company after collection by the company of the purchase price payable to the Funds.

NOTE 2—Operating expenses of general service departments are allocated monthly between F. Eberstadt & Co., Inc. and the company. These and other expenses are paid for the account of F. Eberstadt & Co., Inc. by the company, and are reimbursed on a current basis.

NOTE 3—All of the shares authorized and outstanding are owned by F. Eberstadt & Co., Inc. (a Delaware corporation), successor as of October 31, 1969, to the business heretofore conducted by F. Eberstadt & Co.

NOTE 4—The company holds a lease expiring in 1985, for office space which it shares with F. Eberstadt & Co., Inc. The minimum annual rental on this space amounts to $326,777 through July 31, 1980 and $276,257 from August 1, 1980 to July 31, 1985. Of this amount 40% is borne by the company.

NOTE 5—The company and its parent F. Eberstadt & Co., Inc. are defendants in a derivative action brought in the United States District Court for the Southern District of New York challenging the brokerage practices and the reasonableness of management fees paid by Chemical Fund, Inc.

In an action originally brought in the United States District Court for the District of New Jersey, F. Eberstadt & Co., Chemical Fund, Inc. and Francis Williams were among the named defendants. In its present status, this action asserts a derivative claim on behalf of four funds of which the plaintiff is a shareholder by reason of an alleged combination to fix management fees at excessive levels in violation of the antitrust laws. Neither The Eberstadt Fund nor Chemical Fund is one of such four funds.

PLAINTIFF'S EXHIBIT 35

OPINION OF INDEPENDENT ACCOUNTANTS

To the Board of Directors of F. Eberstadt & Co., Managers & Distributors, Inc.

In our opinion, the accompanying balance sheet presents fairly the financial position of F. Eberstadt & Co., Managers & Distributors, Inc. at August 31, 1971 in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding period. This opinion is based on an examination which was made by us in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

PRICE WATERHOUSE & CO.

New York, N. Y.
October 12, 1971

PLAINTIFF'S EXHIBIT 35

EXHIBIT A

MANAGEMENT AGREEMENT

between

CHEMICAL FUND, INC.

and

F. EBERSTADT & CO.,

MANAGERS & DISTRIBUTORS, INC.

MANAGEMENT AGREEMENT, made this fourteenth day of March 1972, between CHEMICAL FUND, INC., a Delaware corporation (hereinafter called the "Investment Corporation"), and F. EBERSTADT & CO., MANAGERS & DISTRIBUTORS, INC., a Delaware corporation (hereinafter called the "Manager").

WHEREAS, the Investment Corporation has been organized for the purpose of investing its funds in chemical, government and other permitted securities and desires to avail itself of the experience, sources of information, advice, assistance and facilities available to the Manager and to have the Manager perform for it various management, statistical, accounting and clerical services; and the Manager is willing to furnish such advice, facilities and services on the terms and conditions hereinafter set forth;

NOW, THEREFORE, in consideration of the premises and mutual covenants herein contained, it is agreed as follows:

1. The Investment Corporation shall at all times keep the Manager fully informed with regard to the securities owned by it, its funds available, or to become available, for investment, and generally as to the condition of its affairs. It shall furnish the Manager with a certified copy of all financial statements, and a signed copy of each report prepared by certified public accountants, and with such other information with regard to its affairs as the Manager may from time to time reasonably request.

2. The Manager shall furnish to the Board of Directors and officers of the Investment Corporation advice and recommendations with respect to the acquisition, by purchase, exchange, subscription or otherwise, the holding and the disposal, through sale, exchange or otherwise, of securities, and advice and recommendations with respect to other aspects of the business and affairs of the Investment Corporation; and shall, subject to the Board of Directors of the Investment Corporation, manage and supervise the business and affairs of the Investment Corporation. * No security transactions shall be executed through F. Eberstadt & Co., Inc. without the specific approval of a majority of the unaffiliated directors of the Investment Corporation.

3. The Manager shall supply the Board of Directors and officers of the Investment Corporation with all statistical information reasonably required by them and reasonably available to the Manager;

* This sentence not included in present Management Agreement.

shall furnish the Investment Corporation with an office, and with ordinary clerical and bookkeeping services at such office; and shall authorize and permit any of its directors, officers and employees, who may be elected as directors or officers of the Investment Corporation, to serve in the capacities in which they are elected. All services to be furnished by the Manager under this Agreement may be furnished through the medium of any such directors, officers or employees of the Manager.

4. No director, officer or employee of the Investment Corporation shall receive from the Investment Corporation any salary or other compensation as such director, officer or employee while he is at the same time a director, officer or employee of the Manager. This paragraph shall not apply to consultants and other persons who are not regular members of the Manager's staff.

5. As compensation for the services performed and the facilities furnished by the Manager, including the services of any consultants retained by the Manager, effective October 1, 1971, the Investment Corporation shall pay the Manager as promptly as possible after the last days of March, June, September and December, a quarterly fee, as per the following rates, of the average daily net assets of the Investment Corporation during the three months ending on such days.

The fee will be computed in accordance with the table below depending on whether the investment results of the Fund are better or worse than those of the Standard & Poor's Index of 425 Industrial Stocks over periods of the preceding 36 months computed at the end of each calendar quarter at one quarter of the annual rates indicated. The applicable "percentage points", rounded to the nearest hundredth, for any period shall be determined by algebraically subtracting (a) the percentage increase or decrease in the Index for the three years ending with such period from (b) the percentage increase or decrease in the Fund during the same period measured in terms of net asset value per share after adding back capital gains distributions during the period to the net asset value per share at the end of the period.

TABLE OF FEES FOR RELATIVE RESULTS

Chemical Fund's Results Relative to S & P 425 Industrial Index in Percentage Points	First $1 Billion of Assets — Applicable Annual Rate	Next $500 Million of Assets — Applicable Annual Rate	Assets In Excess of $1½ Billion — Applicable Annual Rate
+ 10.01 or better	.40%	.35%	.30%
+ 7.51 to + 10.00	.39	.34	.29
+ 5.01 to + 7.50	.38	.33	.28
+ 3.01 to + 5.00	.37	.32	.27
+ 1.01 to + 3.00	.36	.31	.26
+ 1.00 to − 1.00	.35 (basic)	.30	.25
− 1.01 to − 3.00	.34	.29	.24
− 3.01 to − 5.00	.33	.28	.23
− 5.01 to − 7.50	.32	.27	.22
− 7.51 to − 10.00	.31	.26	.21
− 10.01 or poorer	.30	.25	.20

NOTE: When the average net assets exceed $1 billion, the fee will be computed separately on the first $1 billion and on the assets in excess of $1 billion in accordance with the table above. The results of the separate calculations will be added to obtain the aggregate fee.

The first payment shall be made as promptly as possible after December 31, 1971, and shall constitute full payment of the fee due the Manager for the quarter ended that date. The estimated fee shall be accrued on a monthly basis for the purpose of computing net asset value. If this Agreement is terminated as of any date not the last day of a quarter, such fee shall be paid as promptly as possible after such date of termination, shall be at a rate determined by the Fund's relative investment results for the three years ending on such date of termination as per the table above, applied to the average daily net assets of the Investment Corporation in the period from the beginning of such quarter to such date of termination and shall be at that proportion of such average daily net assets as the number of business days in such period bears to the number of business days in such quarter. The average daily net assets of the Investment Corporation shall in all cases be based only on business days and be computed as of the time of closing of the New York Stock Exchange. Each such payment shall be accompanied by a report of the Investment Corporation prepared either by the Investment Corporation or by a reputable firm of independent accountants which shall show the amount properly payable to the Manager under this Agreement and the detailed computation thereof.

6. Subject to paragraph 4 hereof, there shall be paid by the Investment Corporation (a) the compensation payable to its directors for their services as directors, and (b) the compensation payable to those directors serving on the Portfolio Committee for their additional services as members of this Committee.

7. The Manager assumes no responsibility under this Agreement other than to render the services called for hereunder, in good faith, and shall not be responsible for any action of the Board of Directors of the Investment Corporation in following or declining to follow any advice or recommendations of the Manager.

8. Nothing in this Agreement shall limit or restrict the right of any director, officer, or employee of the Manager who may also be a director, officer or employee of the Investment Corporation to engage in any other business or to devote his time and attention in part to the management or other aspects of any other business, whether of a similar nature or a dissimilar nature, nor to limit or restrict the right of the Manager to engage in any other business or to render services of any kind to any other corporation, firm, individual or association.

9. As used in this Agreement, the term "security," "chemical security," "government security," "other permitted security" and "net assets," defined in Article Ninth of the Certificate of Incorporation of the Investment Corporation, shall have the meanings ascribed to them therein; and the terms "assignment" and "majority of the outstanding voting securities" shall have the meanings given to them by Sections 2(a)(4) and 2(a)(40), respectively, of the Investment Company Act of 1940.

10. This Agreement shall terminate automatically in the event of its assignment.

11. This Agreement may be terminated at any time, without the payment of any penalty, (a) by the Board of Directors of the Investment Corporation or by vote of a majority of the outstanding voting securities of the Investment Corporation by sixty days' written notice addressed to the Manager at its principal place of business; and (b) by the Manager by sixty days' written notice addressed to the Investment Corporation at its principal place of business.

PLAINTIFF'S EXHIBIT 35

12. This Agreement shall be submitted for approval to the Board of Directors of the Investment Corporation annually. This Agreement shall continue in effect only so long as its continuance is specifically approved annually by the Board of Directors of the Investment Corporation *by vote of a majority of those Directors who are not parties to this Agreement or interested persons of any party to this Agreement cast in person at a meeting called for the purpose of voting on such approval, or by vote of a majority of the outstanding voting securities of the Investment Corporation.

13. This Management Agreement shall become effective March 14, 1972 and the terms of the existing Management Agreement, dated May 14, 1971 shall then terminate.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their officers thereunto duly authorized.

CHEMICAL FUND, INC.

By .....
Robert C. Porter, *President*

CORPORATE SEAL

Attest:

By .....
Mary A. Barry, *Secretary*

F. EBERSTADT & CO.,
MANAGERS & DISTRIBUTORS, INC

By .....
Francis S. Williams,
Chairman of the Board

CORPORATE SEAL

Attest:

By .....
David H. Dievler, *Secretary*

* Italicized words to be added.

PLAINTIFF'S EXHIBIT 74.

F. C.
Chemical Fund
Eberstadt

CONFIDENTIAL - FOR DIRECTORS ONLY

January 9, 1967

Defts Exh. For ID 169
Plf. Exh. In Ev .....
Walter Shapiro CSR
Doyle Reporting Inc.
8-29-77

Memorandum to The Boards of Directors of
Chemical Fund, Inc. and The Eberstadt Fund, Inc.

Public Policy Implications of Investment Company Growth

Report of the Securities and Exchange Commission
Transmitted to Congress Under Date of December 2, 1966.

We have given careful study to the above Report and Recommendations of the Securities and Exchange Commission to Congress and have set forth below our preliminary analysis of the Report and Recommendations as they may affect Chemical Fund and The Eberstadt Fund. We do not concur in some of the Recommendations and are not affected by others. It is too early to forecast what legislation may result from Congressional consideration. However, your Manager & Distributor is convinced that any legislation that may be passed by Congress will not impair the value of the shares of either fund. The SEC in transmitting its Report to Congress states "the stress of the Report on regulatory problems and the need for their solution should not obscure the fact that on the whole, investment companies have been diligently managed by competent persons and that the general record of the industry is one of which it can justly be proud".

The Report, however, does reflect almost eight years of work and, therefore, warrants an analysis of the various points reviewed even before specific legislative proposals are put before Congress.

1. Summary of Report

The NASD prepared an outline of the major Recommendations in the Report, which is attached hereto as Exhibit A. The Report itself in Chapter I, pages 7 through 32, sets forth the SEC's summary of the Report. Copies of the Report are available if any Director wishes to review it in more detail.

2. Recommendations Not Applicable

The following Recommendations are not applicable to either fund:

(a) Abolish the front-end load for contractual plan sales. Neither fund has a contractual plan.

(b) Prohibit mutual fund holding companies. No mutual fund holding companies are involved with either fund.

(c) Allow capital gains distributions no more than once a year. This has been Chemical Fund's practice for many years and would call for no change. The same policy applies to The Eberstadt Fund.

(d) Prohibit sales of mutual fund management companies if the sale would impose additional burdens on the fund or its shareholders. No sale of the management company is contemplated.

(e) Tighten curbs on insider trading by fund managers. Both funds already have strict rules prohibiting insider trading and require monthly reports.

3. Recommendations Applicable

(a) Require mutual fund managers' compensation to be reasonable. The SEC recommends that the Investment Company Act of 1940 be amended to provide an express statutory standard of reasonableness for management costs and that the SEC be given statutory authority to institute suit on its own behalf or on behalf of shareholders and to intervene in private actions to recover claimed excesses in management fees. The reasonableness of such costs would be judged by the SEC on the basis of those which prevail in similar institutions such as pension plans, bank common trust funds and internally managed investment companies. Shareholders' or directors' approval would raise no presumption of reasonableness.

The SEC Report on page 134 discusses the 1961 Meiselman decision involving the management fees of Chemical Fund. The Report says, "Meiselman was an atypical case in that it involved an advisory fee rate that had been voluntarily reduced to a level unusually low for the mutual fund industry then or, indeed, now". In a footnote, the Report continues "at mid-year 1966 Chemical's net assets were approximately $437 million. Its 1965 advisory fee amounted to 0.30% of net assets and was still among the lowest in the externally managed sector of the mutual fund industry. ... However, it was more than double the management costs of the internally managed Massachusetts Investors Trust and the companies in the Broad Street complex. The plaintiff in the Meiselman case does not appear to have made any effort to compare the Eberstadt partners' charges to Chemical with the charges that they would have made to non-fund clients for comparable management services with respect to a $300 million portfolio. (See pp. 114-121, Supra.)" The partners of F. Eberstadt & Co. who are also officers of the Funds and the Manager & Distributor, devote either all or a substantial portion of their time to the management and distribution of the Funds. Neither they nor any other partners of the firm act as investment advisers to non-fund clients. The management costs of internally managed funds such as Massachusetts Investors Trust and the companies in the Broad Street complex are discussed below on pages 4 and 5. Their costs are, of course, based on substantially larger pools of assets being managed.

PLAINTIFF'S EXHIBIT 74
- 3 -

The references on pages 114 through 122 deal with a comparison of mutual fund advisory fees versus fees charged other types of investment advisory clients. The references deal principally with fees charged by banks on $100 million pension and profit sharing plans which amount to 0.06% in most of the examples. The Report recognizes that there are differences in the factors effecting the cost of providing investment advice to mutual funds and pension and profit sharing plans that may explain in part the higher fees paid by mutual funds but points out that the bank's charge also includes custodial services which are a separate charge to the mutual fund in most cases. The Report also points out:

"Of course, apart from advisory fees, banks may receive other business benefits from the management of pension and profit-sharing plan assets which do not inure to mutual fund advisers. Moreover, the investment adviser to a mutual fund may incur significant expenses and expend considerable effort in organizing the fund and subsidizing its operations before advisory fees generate sufficient revenue to cover management costs. In view of the vigorous sales competition in the mutual fund industry, the organization of a new fund involves entrepreneurial risk. The adviser at least in part looks to the advisory fee for compensation for this risk.

"Moreover, the responsibility of mutual fund advisers for the operation of the funds is more comprehensive than that normally assumed by advisers to pension or profit-sharing plans. In addition to investment advice and most of the administrative services provided by banks to pension and profit-sharing plans under their management, the mutual fund adviser is usually concerned with administering the fund as a corporate or trust entity. This involves the adviser in various aspects of shareholder relations, including the preparation of proxy material and arrangements for annual meetings, and it must assume the responsibility for compliance with recordkeeping and reporting requirements and other aspects of Federal and State regulation. As previously noted, these services are usually provided by the mutual fund investment adviser and paid for by the advisory fee.

"These functions, however, account for only a portion of the differences between the advisory fees charged mutual funds and those charged pension and profit-sharing plans." The Report dismisses in a footnote the fact that the only bank sponsored fund, that of the First National City Bank, charges a flat fee of 0.50% on the average net assets in the account to the fact that the competitive pressures on advisory fees for this type of account may not be the same as those that have operated on the fees charged by banks for pension and profit sharing plans. It does not refer to the fact that the minimum investment in the First National City Bank Fund is $10,000. It should be noted also that since the date of the Report the United States Trust Company has set up a mutual fund for foreign investors to enable foreign investors to invest in the United States market and is also charging a flat 0.50% management fee. Banks generally charge a fee of 1/2 of 1% on their common trust funds plus a termination fee.

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The Report, while recognizing that the banks receive other benefits from a pension fund, completely ignores the practice of the large banks and trust companies of performing many services for little or no charge in order to obtain substantial balances. You will recall that the Chase is now allowing Chemical Fund 5 1/2% on its balances in excess of $2,700,000 as a credit against the transfer fees. The common practice of the Wall Street trust companies is to give brokerage business from their trust accounts to brokerage firms in return for dollar deposits at the current rate of approximately 8%. In other words, the trust company can afford to handle the pension fund for a very low fee because the brokerage business generated by the trust brings in large deposits from the brokerage firms. Generally speaking, pension funds are also related to other corporate deposit and loan relationships and corporate trust fees. The float on a dividend disbursing account or on pension plan accounts is also very profitable to the trust company. Trust companies which own their own buildings also direct trust brokerage business to tenants which are brokerage firms in order to offset high rentals and obtain full occupancy of their buildings.

We believe, therefore, that the comparison with pension fund fees is completely unrealistic. A recent report on the investment performance of certain bank administered pension funds also indicates that their investment records do not compare favorably with the more continuously supervised and better managed mutual funds.

The Report on pages 102 through 114 compares the costs of internally managed versus externally managed investment companies. The 1965 estimated management cost ratios of the eleven internally managed companies range from 0.12% of average net assets for Massachusetts Investors Trust to 0.36% for Madison Fund, Inc. The median estimated cost ratio for the eleven companies was 0.25%. This compares with the 0.30% (exclusive of directors' fees) for Chemical Fund based on the tapered management fee applied to average net assets in 1966.

The size of the assets managed obviously effects the expense ratio both as to estimated management costs and total expenses. In the case of MIT, with net assets of $2,102,000,000, the total expense ratio was 0.18% whereas in the case of Massachusetts Investors Growth Fund, with assets of $738,900,000, the total expense ratio was 0.38%. The so-called Broad Street Group, with total net assets of $1,346,500,000, had a total expense ratio of 0.19%. However, when brokerage commissions taken by J. & W. Seligman on portfolio transactions are included, the total expense ratio is 0.35%. We estimate that if the present tapered management fee of Chemical Fund was applied to the approximately $1.4 billion of assets of the Broad Street Group, the management fee would be 0.21% and total expenses 0.23%.

There is attached hereto Schedule I comparing the total expenses including management fees and portfolio brokerage as a percent of average net assets of the 20 largest dealer distributed funds which are

not affiliated with direct sales organizations or with brokerage firms which take brokerage on portfolio transactions of the fund. The management performance of these funds is also set forth for various periods ranging from one to ten years. Based on this comparison, Chemical Fund ranks second or third lowest as to the total expense ratio including brokerage. The difference in ranking depends on whether state and local taxes applicable to capital gains are included or excluded from operating expenses. From a performance standpoint, Chemical Fund ranks first over the ten year period ended December 31, 1965 and fourth over the shorter periods shown. Since the performance comparisons add ordinary income dividends to the percentage of gain, the low yielding funds are penalized as against the higher yielding funds. It is interesting to note that Fidelity Trend Fund, with an aggregate expense ratio including brokerage of 2.23%, is nevertheless the best performing fund over the five year period to December 31, 1965. It is also significant to note that Chemical Fund's brokerage commissions are the lowest in the group at 0.10% compared with an average of 0.32%.

Schedule IA is also included showing a similar comparison for the Broad Street Group, Dreyfus Fund and Investors Mutual.

It would appear that the management fee and operating expenses, including brokerage, for Chemical Fund are among the lowest for the externally managed funds and closely competitive with those of the internally managed funds of comparable size. Obviously, the management fee and operating expense ratio of the Eberstadt Fund with only $1 million of assets is substantially higher. However, in accordance with the Blue Sky Laws of the State of Ohio, M & D has agreed that the total operating expenses of the Fund will not exceed 0.75% of average net assets. At an appropriate time, consideration should be given to the possibility of lumping the assets of both funds for the purpose of computing the tapered scale of management fees. This, in effect, would give the Eberstadt Fund the benefit of the present 0.25% management fee applicable to Chemical Fund on those assets in excess of $125 million and 0.20% on those assets in excess of $500 million. It is estimated that even with this reduction in management fee, the average net assets of the Eberstadt Fund will have to exceed $ million before the total operating expenses will be reduced to 0.75%.

The Investment Company Institute is now having an economic survey made to compare the cost of managing mutual funds with other comparable situations.

We believe that the SEC's recommendation that it be given the statutory authority to institute suit on its own behalf or on behalf of shareholders, and to intervene in private actions, to recover claimed excesses in management fees would lead to undue litigation expense and would interfere, from a time standpoint, with the orderly management of mutual funds.

(b) Prohibit give-ups by mutual funds. Chapter IV of the Report recommends that Securities Exchanges adopt plans to grant volume discounts for large investors and at the same time recommends that customer directed give-ups be prohibited. The SEC apparently believes that if volume discounts are granted to mutual funds, the problems of reciprocal business will be shrunk to unimportant proportions.

As indicated in Schedule I referred to above, the total amount of brokerage business of Chemical Fund is approximately one-third the industry average. This is due to the fact that the portfolio turnover of Chemical Fund has averaged between 5% and 9% during each of the last four years compared with a current industry average of 18.7%. The SEC Report emphasizes that portfolio turnover by mutual funds has increased in the last few years and amounted to 27.8% in the first quarter of 1966 and 32% in the second quarter. The annual turnover rates of common stock holdings by selected institutions and on the New York Stock Exchange, 1960-1965, is shown on page 285 of the Report as follows:

	1960	1961	1962	1963	1964	1965
Non-insured private pension plans	4.5%	6.2%	4.6%	6.5%	7.0%	7.1%
Open-end investment cos.	14.7	16.4	14.7	16.6	16.8	18.7
Life insurance companies	7.3	10.2	5.9	9.3	9.1	10.0
Property and casualty insurance companies	(a)	(a)	5.9	7.2	6.9	6.5
N. Y. Stock Exchange (b)	12.4	15.2	12.9	14.5	13.6	14.5

(a) Not available.

(b) Dollar volume of trading for period divided by average of market value of listed stocks; includes preferred stock.

As indicated above, Chemical Fund's turnover rate is substantially below not only the mutual fund average but the average rate for the entire Stock Exchange.

We believe, therefore, that the recommendations of the SEC would benefit both funds in that the volume discount would reduce the cost of operation and the elimination of give-ups would make the funds more competitive from a sales standpoint since they would be purchased on a performance basis rather than a reciprocal business basis, a practice in which Chemical Fund has not been competitive with the industry because of the low amount of brokerage commissions available. The SEC apparently looks with favor on the practice of using brokerage business on portfolio transactions to reduce the cost of management. It strongly endorses the method of operation of the Broad Street complex in which the partners of J. & W. Seligman receive substantial profits from the brokerage business carried out for the investment companies in that complex. It does not refer in this connection to the risks of excessive

portfolio turnover nor to the pending derivative stockholder suits against this complex based on the theory that the funds could save money by using the third market or direct trades. The Report also points out that IDS is now a member of the Pacific Coast Exchange with the fund receiving the full profit on this brokerage business and the fact that the United Fund Group is also a member of the Pacific Coast Exchange with the fund receiving 50% of the profit. They refer to the fact that the brokerage subsidiaries do substantial amounts of Pacific Coast Exchange business for brokers who execute orders for the funds on other exchanges.

(c) Impose a ceiling of 4 3/4% compared with the current level of 8 1/2% on mutual fund sales. Chapter V of the SEC Report recommends that a 4 3/4% ceiling be placed on sales commissions compared with the existing maximum of 8 1/2% of the offering price. This ceiling would be the equivalent of 5% of the net asset value. The Report provides no economic justification for its recommendations nor any evidence that dealers' and salesmens' earnings on the sale of mutual funds are excessive. It fails to recognize that mutual funds are a quite different investment than an individual stock and the method of distribution is quite different and much more costly. The Report fails to recognize that the commission on mutual fund shares is a one-time charge, usually with no charges on redemption. Thus a current commission of 8 1/2% really becomes 4 1/4% when both purchase and redemption are taken into account. At this rate of commission, the charge, even to the small investor, is not excessive. Reasonableness of sales charges should be measured not against the cost of acquiring an individual stock, but against the cost of acquiring even a modest amount of diversification. For the average investor to obtain even a fraction of the diversification available in a mutual fund, the cost would exceed the cost of acquiring mutual fund shares. For example, an initial investment of $4,000 in Chemical Fund results in a sales charge of $340 but gives the investor his proportionate share of the Fund's investments in the securities of 61 different companies. Most investors would not invest as little as $65 in each of 61 securities but if one did, the minimum odd-lot brokerage of $6 on each purchase and $6 on each subsequent sale would amount to $732, more than twice the commission on the mutual fund purchase. The Monthly Investment Plan of the New York Stock Exchange has a minimum commission of 6% on each periodic payment up to $100. When and if the securities are sold, there would be a similar minimum commission of $6 on each transaction under $100. Thus, under the Monthly Investment Plan, if the investor wished to own 61 different stocks, his in-and-out commission charges would be substantially higher than those on a mutual fund and he would not have received the other benefits and services accorded to an investor in a mutual fund. Mutual funds provide a wide variety of attractive services in addition to professional management and diversification, such as accumulation accounts, withdrawal plans, automatic reinvestment, immediate cash redemption without charge, and other conveniences of ownership not generally available through other forms of equity investment. Mutual fund shares are generally held as long term investments and not for trading purposes.

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The average sales commission charged by Chemical Fund over the past three years has been 6.31%, which is but a small fraction of the prevailing commission rates for the sales of insurance, drugs, books, travel services, electrical appliances, jewelry and many other articles of commerce. The list of investor services in the prospectus and quarterly and annual reports of both funds emphasizes the policy of making available to investors quantity discounts through the use of "letters of intent" and "rights of accumulation", which enable an investor to take advantage of the tapered charges on large purchases.

We feel, therefore, that further economic study must be given to the recommendation of the SEC before any changes in sales commissions are considered. The basic concept of the mutual fund industry is to have a continuous flow of funds coming from the sale of new fund shares which will keep the fund in a net sale position rather than in a net redemption position and thus provide for orderly redemptions of the funds' shares without adversely effecting portfolio management. The continuous flow of new funds into an investment trust gives the manager additional incentive in carrying out his investment duties and thus generally improves the long term investment performance of the fund.

Chapter V also recommends that any sales charge on reinvestment of ordinary dividends be eliminated. The practice of both funds has been to permit capital gains dividends to be invested at net asset value without commission but commissions have been charged on the reinvestment of ordinary income dividends. The basic purpose here has been to cover the cost of reinvesting ordinary income dividends which are generally small in amount. It has been felt in the past that each stockholder should pay his share of such cost. However, the SEC Report on page 215 in footnote 58 points out that Rule 22(d)-1 under Sec. 22(d) of the Act "allows a fund to bear the entire cost of a dividend reinvestment plan if every shareholder is given the opportunity to reinvest his dividends at net asset value. If dividend reinvestment is only open to plan participants, the fund cannot bear the expenses of such a plan in excess of the cost of issuing dividend checks". Some funds require the stockholder to pay the 55¢ bank charge on the reinvestment of his dividends.

At an appropriate time, it is recommended that both funds give consideration to amending their present policies to permit every shareholder of the fund to reinvest his dividends at net asset value without sales charge. This might substantially increase the number of stockholders reinvesting their ordinary dividends and would also permit a saving on bank charges if the capital gains and ordinary income dividend at year-end could be reinvested in a single transaction.

With respect to the sales charge in general, it is believed that most distributors of mutual funds, including the undersigned, lose money on the distribution end of their business. This is, of course, not true of some of the larger funds with high sales volume contributed to by reciprocal business.

4. Summary

The management and distribution of a mutual fund is closely regulated not only by the SEC but by the National Association of Securities Dealers and the Blue Sky Commissioners of the fifty states under the applicable Blue Sky laws and regulations of these states. There is no comparable industry which lives more in a "goldfish bowl" than a mutual fund. We believe that the daily publication of prices and the issuance of quarterly and annual reports to stockholders plus an annual prospectus with additional reports filed not only with the SEC but with the NASD and various Blue Sky Commissioners insures every investor that he has adequate information not only before he purchases the shares of a mutual fund but also to determine almost on a daily basis how well the manager is performing his services. Information as to alternative forms of investment is also readily available to each stockholder. In addition, the stockholder has the benefit of the supervision and judgment of the independent members of the Board of Directors of the Fund.

We believe that the long term investment performance of a mutual fund is far more important to the investor than the rate of management fees or sales charges. We believe that the long term performance record of Chemical Fund as shown in the attached schedule is favorable and that its total management expenses, including brokerage commissions, are among the lowest in the industry and fully competitive with other comparable forms of investment medium. We believe that sales commissions are reasonable when considered in the light of "what is necessary to move the merchandise" and thus provide continuing liquidity for the mutual fund investor without undue portfolio turnover.

As indicated above, we recommend that the respective Boards of Directors of the two funds consider taking action at the appropriate time, probably after the Congressional hearings, to:

1. Amending the management contracts of both funds to provide that the present tapered management fee scale be computed on the combined average daily net assets of the two funds or any other funds that may subsequently be managed by F. Eberstadt & Co., Managers & Distributors, Inc. This combination will give the Eberstadt Fund the benefits of the tapered management fee as applied to the larger combined assets of the two funds and may accelerate the point of time in which the stockholders of both funds will receive the benefit of the 0.20% management fee applicable to average daily net assets in excess of $500 million.

2. Giving the stockholders of each fund the opportunity to reinvest his ordinary dividends at net asset value without the imposition of any sales load and that the costs of such dividend reinvestments be charged as expenses of the respective funds.

In addition, we recommend that both funds cooperate with the Investment Company Institute in any studies that it may undertake with respect to the reasonableness of existing management fees or sales loads so as to determine more fully the underlying economic considerations. We recommend that the funds take a position favoring volume discounts for large institutional investors. We recommend that both funds continue the practice of using give-ups until such time as the SEC or Congress shall rule against that practice.

F. EBERSTADT & CO.,
MANAGERS & DISTRIBUTORS, INC.

PLAINTIFF'S EXHIBIT 74 **EXHIBIT A**

Outline of Major Recommendations in the SEC Investment Companies Report

Prepared by National Association of Securities Dealers - December 1966

Chapter I - Background, Scope and Summary

In this chapter, the SEC states, before summarizing its recommendations to the Congress, that:

> "...on the whole the investment company industry reflects diligent management by competent persons. The flagrant abus which prevailed prior to 1940 and prompted the enactment of the Act have to a significant extent been eliminated. Under the guidelines established by the Act the investment company industry has acted responsibly to provide a useful and desirable means for investors to obtain diversification of investment risks and professional investment management. Thus, this report should not impair public confidence in investment companies."

Chapter II - Regulatory Background of the Investment Companies Act of 1940

This chapter gives the legislative history of the 1940 Act and refers to the various problems associated with the growing importance of mutual funds.

Chapter III - Management Cost

SEC Recommendations:

1. The Investment Company Act of 1940 should be amended to provide an express statutory standard of reasonableness toward management costs.

2. Reasonableness of such costs would be judged by the SEC on the basis of those which prevail in similar institutions such as pension plans, bank common trust funds and internally managed investment companies. Shareholders' or directors' approval would raise no presumption of reasonableness.

3. SEC seeks statutory authority to institute suit on its own behalf or in behalf of shareholders to recover claimed excesses in management fees. All papers involved in prospective shareholder suits would be required to be filed with the Commission.

4. The 1940 Act should be amended to prohibit any sale or transfer of investment adviser responsibilities when it appears affirmatively that they are likely to impose additional burdens on the investment company involved.

Chapter IV - Portfolio Transactions, Including Reciprocal Business

SEC Recommendations:

1. Securities exchanges should adopt plans to provide volume discounts for large investors.

2. Any give-ups or other concessions directed by Fund underwriters and management companies to dealers of their choosing should be prohibited.

3. Commissions received by brokers affiliated with mutual fund management companies should be included in judging the reasonableness of management costs.

4. SEC wants authority to require all management companies and investment advisers to adopt Codes of Conduct, meeting a specified minimum standard, that would require reporting of all employees' securities trading activities.

5. Prohibit capital gain distributions more than once per year.

Chapter V - Distribution and Cost

SEC Recommendations:

1. The 1940 Act should be amended to limit sales charges on fund shares to 5 percent of net asset value. This would be equivalent to 4 3/4 percent of the offering price and contrasts with the present level of approximately 8 1/2 percent of offering price.

2. The 1940 Act should be amended to give SEC authority to adjust maximum sales charges as it deems appropriate.

3. All dividends should be required to be reinvested at net asset value rather than at the public offering price, thus eliminating any sales charge on dividend reinvestment.

4. Contractual plan "front end loads" should be abolished and total sales charges on contractual plans and Face Amount Certificates would be limited to 5 percent of net asset value, or 4 3/4 percent of the offering price.

Chapter VI - Size of Funds and Investment Performance

The SEC recommends no size standards should be set, beyond the present minimum requirement in the Act. The report states that the Commission will continue to observe the effects of size on performance.

Chapter VII - Investment Company Growth and Market Impact

SEC Recommendations:

1. The Commission seeks authority to require the availability to the SEC of information on transactions and other statistical data of all financial institutions including mutual funds, pension plans, banks, insurance companies and charitable foundations.

Chapter VIII - Investment Company Relationships With Portfolio Companies

SEC Recommendations:

1. Mutual fund holding companies should be prohibited. This would eliminate mutual funds' purchasing shares of other mutual funds.

Chapter IX - Administration of the Investment Company Act

This chapter contains recommendations for numerous technical changes in the Act and in the Investment Advisers Act of 1940. A few of these are:

1. The registration of a series of funds under one registration statement should be prohibited; rather, each fund in a "series" should be registered separately.

2. Sales charges on exchanges of funds within a group or "family" should be prohibited.

3. The Act should be amended to bar any of the persons now specified in section 9 of the Act, who have violated any provisions of the 1933, '34 or '40 Acts, from being affiliated with a management company or fund.

4. The Act should be amended to give the SEC authority to bar any person from certain affiliations with investment companies for "abuse of trust" and to seek to enjoin any such affiliation for "breach of fiduciary duty" as determined by the Commission.

5. The Investment Advisers Act should be amended to give the Commission authority to proceed directly against individuals without the necessity of joining the employing firm.

6. The Investment Advisers Act should be amended to eliminate management compensation based on fund performance, such as those based on comparison with a market index or on appreciation of net asset value per share.

PLAINTIFF'S EXHIBIT 75.

SULLIVAN & CROMWELL

FILE COPY

MR. ☐
" ☐
" ☐

PLEASE NOTE AND
RETURN ☐
FILE ☐
ATTEND ☐
SEE ME ☐
PASS ON ☐

CLIENT CHEMICAL FUND, INC. February 20, 1968

MATTER General

The Board of Directors,
Chemical Fund, Inc.,
65 Broadway,
New York, New York.

Dear Sirs:

You have asked us to review the method by which F. Eberstadt & Co., Managers & Distributors, Inc. (the "Manager") places brokerage orders for Chemical Fund, Inc. (the "Fund") and directs the allocation of a portion of the brokerage commissions arising therefrom to brokers other than the broker executing the order. As you know, F. Eberstadt & Co., the sole stockholder of the Manager, became a member of the New York Stock Exchange in 1962 and, since that time, as a matter of policy, has not executed brokerage orders for the Fund or requested or received "give-ups" on business done for the Fund by other brokers on the New York or other stock exchanges.

We have reviewed Securities Exchange Act Release No. 8239, dated January 26, 1968, which discusses, among other things, the level and structure of commission rates on the New York Stock Exchange, the practice of reciprocity and "give-ups", and the possibility of a manager receiving commissions or "give-ups" in connection with a fund's portfolio transactions in reduction of the management fee by all or a portion of such brokerage commissions or "give-ups." The Release also proposes the adoption of Rule 10b-10 under the Securities Exchange Act of 1934. We

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Walter Shapiro CSR
Doyle Reporting Inc.
8-29-74

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understand that you have received a copy of this Release. We have also examined the Investment Company Act of 1940 and such other matters of law as we have considered appropriate.

On the basis of the above and assuming that the Board of Directors has considered all the relevant facts concerning this matter, including the possibility of adopting alternate methods of handling the Fund's brokerage business whereby a portion of the commissions might be used to reduce the management fee, and assuming further that, as a result of such consideration, the Board of Directors has come to the conclusion as a matter of reasonable business judgment that it is in the best interest of the Fund and its shareholders that the continuation of the present method of placing brokerage orders and directing "give-ups" be approved, it is our opinion that such approval would be lawful.

Very truly yours,

SULLIVAN & CROMWELL

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PLAINTIFF'S EXHIBIT 76.

Report to the Unaffiliated Directors of Chemical Fund, Inc. on the Management and Distribution Agreements with F. Eberstadt & Co., Managers & Distributors, Inc.

Purpose of the Report

A role of the unaffiliated directors is to review the management and distribution agreements to satisfy themselves that renewal is justified and, if so, whether the same or different terms are reasonable and in the best interests of the stockholders. Many factors are to be considered, especially the relative performance of the fund and the relative cost to stockholders.

The purpose of this report of your subcommittee is to summarize briefly the conclusions which have emerged from our review of the relevant factors. We are prepared to respond to any questions which any director may care to raise.

Performance

The most important question before us is the integrity and quality of the management organization. The officers of the Fund, whom we have elected, are the executive officers of the manager and distributor. We have repeatedly passed upon their integrity in electing them and have found no reason of any kind to question this judgment.

The quality of investment management can be measured, at least in part, by the returns to stockholders over the recent past and over a longer span of years. In this type of fund, with long-term capital growth as the primary objective, a rough measure is the percentage of net increase in asset values adjusted for capital gains distributions. A valid comparison, in our opinion, is with Massachusetts Investors Growth Stock Fund and National Investors, both of which are well managed, seek similar objectives, and invest in stocks of good quality. The record is as follows:

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Adjusted Net Increase in Net Assets

	One Year 1967	Six Years 1962-1967	Twelve Years 1956-1967
Chemical Fund	28.8%	78.0%	199.3%
M. I. Growth	27.3	56.4	182.5
National Investors	29.4	56.9	187.2
S & P 425 Industrials	23.3	38.8	109.9

This record of performance entitles the Fund to be ranked among the best managed of its type. We believe that profit incentive has contributed to these favorable results for stockholders and that this incentive should be maintained. As in most fields of business, good management is economical; only poor or mediocre management is expensive. The stockholders are best served, in our opinion, by paying the managers well and holding them to high standards of proficiency.

We are not so favorably impressed with the distribution of the Fund's shares, although the performance has been adequate in sustaining the Fund's investible funds. The losses sustained in distributing shares are, we think, an appropriate incentive of a different kind to encourage the devising of a more efficient and effective effort. We believe that such losses are a proper offset to the profits derived from the management function.

Compensation

The scale of management fees and distribution commissions is in line with or below those generally prevailing in the mutual fund business. The total operating expense ratio of the Fund was 0.37% in 1967, compared with 0.47% five years ago and 0.54% ten years ago. This is a favorable trend and the current figure is below the comparable ratio for funds of similar size. As emphasized above, however, this statement is meaningful only in relation to investment performance.

It is our conclusion that the management fee is reasonable in light of the results being achieved and we recommend renewal of the management agreement on the same terms. The distribution commission scale approximates the standard for other load funds. We see no reason to change this arrangement.

In Release No. 8239 dated January 26, 1968, the SEC discusses the level and structure of commission rates on the New York Stock Exchange, the practice of reciprocity and "give-ups" and the possibility of a manager receiving commissions or "give-ups" in connection with a fund's portfolio transactions in reduction of the management fee by all or a portion of such brokerage commissions or "give-ups". We have studied this Release and the proposal to issue Rule 10b-10 on the subject of give-ups and we also read the opinion of Messrs. Sullivan & Cromwell addressed to the Board of Directors of Chemical Fund dated February 20, 1968 dealing with this subject.

In 1967, as fully disclosed in the proxy statement, the Fund paid brokerage commissions of $618,000. Of this amount, $510,000 was allocated to dealers based on the volume of Fund shares sold. The allocation of brokerage business and the use of directed give-ups can be regarded as additional compensation to dealers who sell Fund shares. This is a long established practice of the business, which has been followed by Chemical Fund with the full knowledge of the Board and the stockholders. In addition to the information regularly provided in proxy statements, prospectuses and Form N-1R, the manager has reported from time to time and the Board has approved these practices. The specific allocations to individual brokers are made by the fund's officers without prior review by the directors but in accord with the general policy approved by the Board.

We quote from the SEC release as follows: "Many mutual fund managers believe that so long as this type of sales incentive can be given to dealers, competition among mutual fund managers for the favor of dealers will make it difficult,

if not impossible, for any individual fund manager to fail to provide such compensation to dealers, both members and nonmembers of exchanges, selling shares of his funds." We agree completely with this statement. Regardless of the merits of this method of doing business, it is not practical to attempt a change for Chemical Fund at this time even though we recognize that it would be possible to request the manager to execute some portfolio transactions as a member of the New York Stock Exchange or request give-ups on portfolio transactions which would be credited against the amount of the management fee.

We believe that the directors must look upon this question realistically and in proper perspective. Chemical Fund has a very low portfolio turnover rate. The Board retains close control over that rate of turnover. We are mindful of the fact that through the portfolio committee as presently constituted the unaffiliated directors have, in effect, power over portfolio transactions and this power has been frequently exercised. Therefore, management does not really exercise complete control over the generation of commission business for the purpose of stimulating sales. While we recognize fully that allocation of the purchase and sale orders is an additional resource to the distributor, we are not impressed with either its size or the possibility of abuse. We propose, therefore no change in this arrangement and recommend approval of a continuation of the past practice of leaving the allocation of brokerage commission business to the officers of the Fund.

Conclusions

Based on our review of statements of income and expense of the Manager & Distributor, data for other funds, and our appraisal of services rendered to the Fund, we make the following recommendation to the unaffiliated directors: Based on our appraisal of the quality of the management and distribution services being provided to Chemical Fund, we recommend renewal of the present management and

distribution agreements for another year on the grounds that the compensation is reasonable and that continuation of the present arrangements is in the best interests of the stockholders of Chemical Fund, Inc.

Respectfully submitted,

Burt N. Dorsett
Roger F. Murray

February 21, 1968

PLAINTIFF'S EXHIBIT 77.

F. EBERSTADT & CO.,
MANAGERS & DISTRIBUTORS, INC.
61 BROADWAY, NEW YORK, N. Y. 10006
(212) 944-8787

August 17, 1971

Def. Exh. For ID 172
Pl. Exh. In Ev .....
Walter Shapiro CSR
Doyle Reporting Inc.
8-29-74

Memorandum to Messrs. Driscoll and Murray
Subcommittee of Board of Directors of
Chemical Fund, Inc. to review Management
and Distribution Contracts

In your report of February 17, 1971 to the Board of Directors of Chemical Fund in connection with the consideration of the renewal of the management and distribution contracts, you recommended that the entire question of the best distribution method for Chemical Fund shares be reviewed again not later than the September board meeting. This recommendation was based on the fact that possible changes in the commission structure would effect competitive conditions in the sale of Fund shares and that the distribution function still produces an operating loss for M & D. You also noted that T. Rowe Price Growth Stock Fund, a no-load fund with no better recent record, showed a superior record of net sales.

At the June 1971 meeting, you were appointed as members of a subcommittee together with Mr. Fox to review the allocation of portfolio brokerage business of the Fund in light of the decision by the First Circuit Court of Appeals in the Fidelity Management case. This decision contained language which raises the question of whether the unaffiliated directors of a mutual fund have the legal power not to recapture brokerage commissions for the benefit of the fund if such recapture is freely available. The possibility that Chemical Fund might work out an arrangement through the firm of F. Eberstadt & Co., Inc., which is a member of the New York Stock Exchange, whereby a portion of the portfolio brokerage business could be done with that firm and a portion of the brokerage commissions credited against the expenses of managing and selling the Fund has been discussed with the Board each year and the Board has affirmatively directed that this not be done without prior clearance with it. Such discussions have assumed that if such an arrangement was desirable and was acceptable to F. Eberstadt & Co., Inc. the Rules of the Exchange would permit it. In the testimony of the Fidelity case there was some question of whether the Exchange Rules would in fact permit such a course of action. Management is now reviewing with the New York Stock Exchange whether such an arrangement is actually permissible under its interpretation of existing rules. The possibility of working out such an arrangement through the Pacific Coast Stock Exchange or other regional stock exchanges through some form of preferred rate arrangement for NASD members is also being explored by our counsel, Messrs. Sullivan & Cromwell.

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In addition to these explorations, there are a number of other factors which should be considered which are still unsettled:

1. The Martin report has just been issued and recommends that members of the NYSE spin-off the management of investment companies from the brokerage business.

2. The 1970 amendments to the Investment Company Act directed the NASD to consider the scale of distribution fees for registered investment companies and this study is now in progress.

3. The present commission rate structure of the NYSE is now under review by the SEC.

4. The effect of negotiated commissions is still not fully developed and the question of whether the $500,000 level will be reduced to a substantially lower level is still to be determined.

5. The language of the Fidelity Management case indicated that the directors may have no choice in these matters because of charter provisions and the question of whether the Certificate of Incorporation can be amended to give the directors such a choice is now being considered by counsel.

In the meantime, the trend of sales of Chemical Fund's shares continues to be favorable through the first six months of 1971 as shown in the table below and the losses on Fund distribution have been reduced to almost the breakeven point for the first six months of 1971.

	$ Millions		
Year	Sales*	Redemptions	Net Sales
1971 (6 months)	$28.2	$12.7	$16.5
1970	37.2	22.4	14.8
1969	24.6	20.3	4.3
1968	22.9	23.2	(0.3)

* Excluding reinvestment of capital gains distributions.

Under these circumstances, the Manager recommends that the explorations with the New York Stock Exchange and the other regional exchanges as to the recapture of brokerage business be diligently pursued but that no final decisions be made as to a change in the method of distribution of the Fund or the method of handling brokerage business until some of the uncertainties referred to above have been clarified.

R. C. Porter

SECURITIES EXCHANGE ACT RELEASE NO. 8239.
January 26, 1968.

The Securities and Exchange Commission announced that the New York Stock Exchange has submitted for Commission comment and reaction the outlines of a proposal for certain revisions of its commission rate structure. A copy of that proposal is attached to this release. As described more fully below, the Exchange proposal generally contemplates (1) provision for a volume discount in commissions, (2) access to the exchange market for qualified nonmember broker-dealers through a professional discount, (3) recognition of limited customer directed "give-ups" of commissions to both members and nonmembers on New York Stock Exchange executions and limitations upon reciprocal business, (4) a prohibition of procedures by which institutional investors may recapture a portion of the commissions paid by them and (5) a requirement that the regional exchanges impose similar restrictions.

The Commission also announced that it has under consideration a proposal to adopt Rule 10b-10 under the Securities Exchange Act of 1934. The rule, essentially, would prohibit investment company managers from directing brokers executing transactions for an investment company to divide their compensation in any way with other brokers unless the benefits of such division accrue to the investment company and its shareholders. The rule would be adopted pursuant to the antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 and certain provisions of the Investment Company Act of 1940.

Since the proposal of the Exchange as well as the proposed Commission rule would have significant impact upon New York Stock Exchange member firms, nonmember broker-dealers, institutional investors, other exchanges and the public, the Commission believes it appropriate that all interested persons have an opportunity to comment not only on the proposed Commission rule but also on the Exchange's proposal.

Both the proposed Commission rule and the proposal of the Exchange arise out of certain problems presented by the great increase in institutional investment and the complex and rapidly developing pattern of practices and procedures in the securities markets associated with that increase which are commonly referred to as "give-ups and reciprocal business." Proposed Rule 10b-10 is limited in scope. It assumes that present give-up practices will continue and accordingly deals primarily with the question of conduct by fiduciaries in that context. The New York Stock Exchange proposal is more far reaching and, particularly insofar as it involves a volume discount, suggests the possibility that the problem with which the proposed rule is concerned could be dealt with in a more direct and thoroughgoing way by changing the commission rate structure. For this reason and because in certain respects the proposed rule of the Commission and the Exchange proposal are inconsistent, the Commission further believes it appropriate to afford interested persons the opportunity not only to comment with respect to both the proposed rule and the Exchange proposal but to suggest, if they so desire, alternative means of dealing with the serious and difficult problems presented.

Any consideration, both of these proposals and of the practices and procedures to which they relate, must include careful attention to their impact upon competition, including competition among securities firms, competition among markets and competition among institutional investors. This is mandated by the antitrust laws and the policies underlying these laws. As the Supreme Court has pointed out, the Exchange commission rate structure includes a number of practices which would clearly violate the antitrust laws absent the Securities Exchange Act and notwithstanding the Securities Exchange Act the exchanges do not enjoy a blanket exemption from the antitrust laws. Nevertheless where the Commission has jurisdiction to review and pass upon particular Exchange activities, as it has in the area of commission rates under Section 19(b) of the Exchange Act, antitrust immunity may, under some circumstances, be implied.[1] Such immunity would be implied to the extent necessary to recon-

[1] *Silver v. New York Stock Exchange*, 373 U. S. 341 (1963). See also *Kaplan v. Lehman Bros., et al.*, 250 F. Supp. 562 (N. D. Ill., 1966), *aff'd* 371 F. 2d 409 (C. A. 7, 1967), *certiorari denied*, -- U. S. —, the Chief Justice dissenting, (1967).

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cile the statutory scheme of the Securities Exchange Act with that of the antitrust laws. This necessarily contemplates that full consideration be given to the policies of the antitrust laws as well as those of the Securities Exchange Act in evaluating any aspect of the commission rate structure or any proposals for its revision. Whether or not the mere existence of Commission jurisdiction necessarily creates an immunity from the antitrust laws was left open by the Supreme Court in the *Silver* case. However this may be, it is clear that antitrust considerations should receive the closest scrutiny.

BACKGROUND

The Commission believes it useful to outline briefly the situation which prompted both the New York Stock Exchange's rate structure proposal and proposed Commission Rule 10b-10 with the expectation that this may contribute to understanding and analysis of these proposals.

In recent years institutional investors, including banks, insurance companies, pension plans and investment companies have accounted for a steadily increasing share of the volume of trading on the exchanges. On the New York Stock Exchange institutional volume as a percent of total public volume has increased from 25.4 percent in March 1956 to 33.8 percent in September 1961, to 39.3 percent in March 1965 and 42.9 percent in October 1966, the latest date available. It should be recognized that these institutional investors usually represent a pooling, under professional management, of savings belonging to a great many individuals, most of whom are small investors. Consequently securities market conditions and practices which affect the investments of these individuals are of wide public interest.

These institutions tend to deal in larger blocks of securities than individual investors ordinarily do. Consequently increasing institutional participation in the exchange markets has been accompanied by a significant increase in the number of large blocks offered and traded. Studies by the New York Stock Exchange show that the number of transactions involving 10,000 shares or more has increased from 2171 in 1965 to 6685 in 1967, that the number of shares involved in these transactions has more than tripled, and that their share of reported volume has increased from 3.1 percent to 6.5 percent.

This situation has thrown an increasing strain on the rigid minimum commission rate structure, adopted many years ago by the New York Stock Exchange and followed by all other national securities exchanges, which is based upon a single round lot, usually 100 shares. There is no volume discount based either on the size of the individual order or upon the amount of portfolio business done by an institution or upon the amount of portfolio business done by an institutional investor over a period of time. Thus the commission which a member firm is required by Exchange rules to charge its customer on a 10,000 share transaction is 100 times the commission it is required to charge on a 100 share transaction and the commission on 100,000 shares is 1000 times the commission on 100 shares. Ostensibly all persons who are not Exchange members must pay the minimum commission. There is no distinction among different kinds of nonmember, e.g., nonmember brokers, individual customers, institutional investors, etc.

While orders to buy or sell large blocks involve greater demands on a broker than the execution of a single round lot order, it does not cost a broker anywhere near 100 times as much to execute a 10,000 share order than to execute a 100 share order. Indeed, for certain aspects of the execution process, such as bookkeeping, the cost is essentially the same. As is true in other areas of the business world, broker-dealers engaged in effecting such transactions have enjoyed the great advantages of scale accruing from large transactions. These institutional transactions generally do not involve the payment of a commission to a salesman of the broker, although an institutional brokerage business usually does entail the expense of maintaining an institutional trading department and the development of special talents. Consequently, the executing brokers are willing to accept substantially less compensation for executing institutional orders, particularly large institutional orders, than is contemplated by mechanical application of the existing minimum commission rate rules of the exchanges.

Managers of institutional investors have taken advantage of the competition among brokers for institutional business, and the willingness of such brokers to accept compensation far lower than that contemplated by the Exchange rules, to divert or recapture portions of the commission paid on institutional orders. An increasingly complex pattern of practices having this objective has developed. Many of these practices involve the so-called "give-up"

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A "give-up" is a payment by the executing broker to other broker-dealers of a part of the minimum commission he is required to charge his customers. Under the rules of the stock exchanges, the payment may be made on the executing broker's own initiative and for his own purposes or it may be directed by the customer. The recipient of a "give-up" check may have had nothing whatsoever to do with the transaction for which the commission is charged and in fact may not even know of the transaction or where or when it was executed. Thus "give-ups" have been widely used in connection with mutual fund portfolio transactions. Managers of mutual funds direct give-ups, for the most part to broker-dealers who have sold fund shares in order to motivate, or reward, such sales effort. On certain orders, the executing broker may retain as little as 25 percent of the commission paid by the fund and give up the balance. Brokers who sell fund shares are thus compensated for their efforts not only by receipt of the dealer's portion of the "sales load" but also by substantial amounts of give-up dollars generated at the direction of the manager of the fund through purchases and sales of fund portfolio securities. Fund managers also often use give-ups as a reward for research it has furnished to them in their capacity as investment advisers to the fund.

While the New York Stock Exchange permits its members to give up commissions only to other members of that Exchange, the smaller regional exchanges have with increasing success, competed with the New York Stock Exchange for institutional business, particularly the business of mutual funds, by permitting give-ups of commissions not only to members of the particular exchange but also to any member of the National Association of Securities Dealers, Inc. or even to any registered broker-dealer. By requiring that an order be taken to a regional exchange, a mutual fund manager is able to provide more reward to broker-dealers who sell shares of the mutual fund but who are not members of the New York or of any exchange.

Give-ups are widely used in connection with so-called "cross" transactions. These involve situations where the order cannot be adequately executed in the auction process off the floor of an exchange and therefore the institutional broker finds the other side of the trade on the floor, *i.e.*, locates a seller if he has an order to buy or a buyer if he has an order to sell, and then merely records or "crosses" the order on the floor. Exchange rules do not allow member brokers to consummate crosses in their offices or in the over-the-counter market at a negotiated commission, but they do allow the broker to send the transaction to any exchange of which he is a member and to give up from the commissions he must charge on the cross in accordance with the rules of that exchange. By this means large institutional orders can, nominally at least, be executed on small regional exchanges, but where this occurs the usual motive is simply to take advantage of the rules of that exchange with respect to the classes of persons who may receive give-ups.

In addition to the give-up, there have developed complex practices by which executing brokers provide compensation at the direction of institutional investors to other brokers by means of reciprocal business, *i.e.*, permitting such other brokers to participate in the commission generated from execution, in the over-the-counter market or on regional exchanges, of orders which the institution's broker has received from *other* customers. More recently, certain member firms of the New York Stock Exchange have developed a procedure whereby they can compensate nonmembers of the New York Stock Exchange at the direction of mutual fund managers by paying cash to such nonmembers and crediting such payments on over-the-counter trades for unrelated customers, whether or not commissions were in fact charged on such trades. The compensated dealers have no participation in these trades and, in fact, may never have heard of the trades at the time when they were executed.

[*Widespread Use of Give-ups*]

Give-ups and reciprocal business practices in connection with institutional trading have become so widespread that it may plausibly be argued that, in the case of large institutional orders, there is in economic substance no fixed minimum commission. Commissions are negotiated between institutional managers and their "lead" brokers with the lead broker on occasion retaining no more than 25 percent of the ostensible minimum commission. This situation is perhaps most strikingly illustrated by procedures which have been developed and which enable institutional investors to recapture a portion of commissions for themselves. Many mutual fund managers have affiliates which are registered as broker-dealers; many of these affiliates are members of the NASD. A small number of mutual fund managers have created affiliates which

have joined a regional stock exchange. In the latter situations, the manager directs that give-ups and reciprocal business be given by its lead brokers to its affiliates. It then credits the net income thus received by the affiliate, in whole or in part, against the advisory fee it receives from the fund. This results in lowering the advisory fee by all or part of the net income the manager has thus obtained. Through this means, public shareholders of institutions can, within the framework of existing practices developed by the securities industry, recoup substantial amounts of commissions actually paid for the execution of their portfolio orders despite a rigid commission structure which does not otherwise permit the institution to benefit from the very substantial portfolio business it may have to dispense. In one instance the advisory fees charged to a large complex of mutual funds by their common manager were lowered in the aggregate by approximately $3.1 million for the year 1966, this sum being the approximate net profit of the manager's broker-dealer affiliate. Other managers have elected to credit the advisory fees they charge by only 50 percent of the net profits of their broker-dealer affiliates. In a few instances, the mutual fund manager has kept all give-ups it has directed to its brokerage affiliate for itself without lowering the advisory fees it charges to the fund whose portfolio transactions are the source of such give-ups.

Although these techniques permit fiduciaries who manage a pooled fund to return a portion of portfolio commissions to the shareholders of that fund, they have to date been employed mainly by the managers of those mutual funds whose shares are sold by the manager's own "captive" sales force. Managers of those mutual funds which are distributed by independent broker-dealers have almost always used the excess brokerage to provide additional reward to dealers who sell shares of the fund rather than endeavoring to recapture such brokerage for the fund. This is because by so compensating dealers these mutual fund managers facilitate the sale of shares and thus maximize their own underwriting and investment advisory income. Many mutual fund managers believe that so long as this type of sales incentive can be given to dealers, competition among mutual fund managers for the favor of dealers will make it difficult, if not impossible, for any individual fund manager to fail to provide such compensation to dealers, both members and nonmembers of exchanges, selling shares of his funds. In this connection the Commission has been informed that certain large member firms of the New York Stock Exchange, who maintain extensive mutual fund departments and are a significant factor in the sale of mutual fund shares through dealers, have suggested to mutual fund managers that brokerage be channeled to them if they are to continue to sell shares of the manager's funds.

The net effect of the foregoing developments have been (1) a dramatic increase in the volume of transactions on regional exchanges,* (2) a "diversion" of commissions which otherwise might have been retained by New York Stock Exchange members to (a) other members who perform no function in connection with transactions and (b) nonmembers of the New York Stock Exchange who perform no function on transactions effected by New York Stock Exchange members on regional exchanges, and (3) a developing trend whereby excessive commissions—the amounts which, at the direction of institutional managers, executing brokers are willing to give up to persons who perform no service or function in connection with the execution of portfolio transactions—are returned, at least partially, to the institutional customers thereby indirectly benefiting the millions of investors who invest through pooled media such as mutual funds. In short, competition in the securities industry between institutional managers and brokers and between exchanges, has operated to reduce very substantially the amount of commissions actually *retained* by executing brokers —but with relatively little impact or effect as yet on the commissions actually *paid* by the public investors who invest through institutional media.

In addition to practices with respect to commissions on institutional transactions, there are certain related competitive phenomena which deserve mention. As previously noted, the New York Stock Exchange rate structure expressly provides that non-

* In 1961 the total dollar volume of transactions on regional exchanges was $4.4 billion; in 1966 it was $10.3 billion. This represented 6.8 percent of the dollar volume of transactions on all exchanges in 1961 and 8.4 percent of such volume in 1966. By comparison New York Stock Exchange dollar volume increased from $52.7 billion in 1961 to $98.6 billion in 1966; and New York Stock Exchange transactions declined from 82.6 percent of total dollar volume of exchange transactions in 1961 to 80.1 percent of such transactions in 1966. Dollar volume on the American Stock Exchange accounts for the balance. Substantially all of the regional exchange volume consists of trading in securities also traded on the New York Stock Exchange.

members of that Exchange—including broker-dealers who are members of a regional exchange—must pay a New York Stock Exchange member a full commission for transactions executed on the New York Stock Exchange. Nevertheless, reciprocal business practices have developed which now give such regional exchange members indirect economic access to the floor of that Exchange.

For example, when a broker-dealer cannot execute its customer's order on the regional exchange of which it is a member, it has the order executed on the New York Stock Exchange, pays a New York Stock Exchange member a full New York Stock Exchange commission and collects that amount from the customer. Thus, the sole member of the regional exchange receives no direct compensation for its customer's order. However, it can receive indirect compensation equal to 50 percent of the commission paid by the customer. The member of the New York Stock Exchange through whom the order was executed brings its own customers' orders to the regional exchange, executes them there and names the sole member broker-dealer as the "clearing agent." Typically, under the rules of regional exchanges, the sole member may receive up to 50 percent of the stock exchange commission for acting as "clearing agent" on such orders, although he performs no function except the largely unnecessary one of guaranteeing performance by the New York Stock Exchange member.

Recent years have also seen a substantial growth in the so-called third market. This involves securities firms which are not members of any exchange and which deal in listed securities over-the-counter, both as principal and as agent, largely for institutional customers and broker-dealers not members of an exchange. Since exchange minimum commission rates do not apply to them, they have been able to execute orders either as principal or as agent for compensation substantially less than that provided for in the minimum commission rate rules. On the other hand, their ability to compete for institutional business has been adversely influenced by the fact that they are not in a position to provide give-ups for the benefit of institutional managers, since give-ups have generally been regarded as proper only where a minimum commission rate is applicable. Two incidents illustrate this point. One firm at one time specialized in executing institutional orders for listed securities in the over-the-counter market at a negotiated commission lower than that provided by exchange rules. Certain mutual fund managers suggested that it join a regional exchange and thus charge the higher commissions specified by the exchange and, at the same time, place itself in a position to distribute give-ups at the request of these managers and it did so in order to retain their business. Another large over-the-counter firm advised the Commission that instead of negotiating its compensation on each large institutional trade, it proposed unilaterally to establish a fixed non-negotiable commission but to give up a portion of this commission at the direction of mutual fund managers. This arrangement, which has not yet been put into effect, was motivated not because the firm thought that its existing negotiated compensation was inadequate but, rather, because it believed that its ability to provide give-ups would substantially improve its competitive position in seeking business from mutual fund managers even though its regular charges imposed on the funds were already lower than the New York Stock Exchange fixed minimum commission.

The Commission's jurisdiction under Section 19(b) of the Securities Exchange Act over Exchange rules with respect to "the fixing of reasonable rates of commission" obviously extends both to the commission rate level and to the commission rate structure. Particularly in the earlier years the Commission's attention appeared to focus primarily on questions of level, although questions of structure also arose. The history of this consideration since 1937 is outlined in considerable detail in the Report of the Special Study of Securities Markets.[8] As there pointed out, determination of a reasonable level of minimum rates for an industry as diverse, complex and, in a sense, competitive as the New York Stock Exchange brokerage community presents perplexing problems. In addition, questions of structure and questions of level are intimately related. Thus the Exchange proposal for a volume discount pertains to rate level as well as structure and is a response to the fact that the existing level of rates for large institutional transactions has, as a result of competitive factors, fostered the proliferation of give-ups and reciprocal practices.

These practices and problems, as outlined above, some of which are relatively

[8] Special Study, Pt. 2, 328-346. H. R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

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recent origin, have been the subject of intensive consideration by the Commission over a period of years. Reciprocal business practices and customer directed give-ups were described in the Report of the Special Study of Securities Markets.[4] It was suggested that they be studied in connection with an intensive inquiry into all aspects of the commission rate structure. They were further discussed in the Commission's 1966 Report on the Public Policy Implications of Investment Company Growth.[5] Approximately 19 months ago the Commission advised the exchanges of its belief that Exchange rules should be changed to preclude customer directed give-ups.[6]

Since consideration of the New York Stock Exchange proposal necessarily would involve an understanding and consideration of possible alternatives, the Commission believes that proposed Rule 10b-10 should now be noticed for comment. The Commission would thus be in the best position to consider all alternatives, including any which may be suggested.

THE EXCHANGE PROPOSAL

The first item of the New York Stock Exchange proposal involves the establishment of a volume discount. The Exchange has not yet determined the amount of such discount or the circumstances under which it would be available. There are a number of possible alternatives, including (1) a discount based upon the size of a particular order and (2) a discount based upon the volume of a particular investor's transactions over a specified period of time. The Commission assumes that the discount ultimately arrived at would be meaningful and workable. Upon that assumption it would appear that this part of the Exchange proposal would make an important contribution to resolving the problems discussed above and be in accord with suggestions that the Commission has made to the exchanges on several occasions.

Several other parts of the Exchange proposal appear to be based on the view that (1) the relatively untrammeled development of reciprocal and give-up practices, (2) the competitive advantages which regional exchanges have sought in competing for institutional business by increased liberality with respect to give-ups, and (3) the resulting "leakage" of commissions outside the New York Stock Exchange community, as threatening impairment of the depth and liquidity of the New York Stock Exchange market as well as the profitability and financial stability of member firms.

The Exchange proposal seeks to relieve this situation by (1) limiting to the extent possible the major types of reciprocal business, (2) specifying the maximum percentages of the commission dollar which may be given away in any manner or, alternatively, specifying the minimum amount which must be retained, (3) preventing the regional exchanges from offering different and more liberal give-up arrangements so that institutional or other investors will not seek to execute or cross their transactions on regional exchanges in order to obtain more favorable give-ups, and (4) preventing what is some times referred to as "institutional membership" on exchanges, which appears to include membership of affiliates of an institutional investor whose function is to receive give-ups and reciprocal business and in whole or in part to pass the income therefrom back to the institutional investor itself. This is a significant part of the New York Stock Exchange proposal which would have a particularly important effect upon the securities markets, and would require action by the Commission. Consequently, comment with respect to it would be appreciated. These aspects of the Exchange's proposal may be viewed together as designed to make its minimum commission rates effective and enforceable insofar as large institutional transactions are concerned.

It would appear that the New York Stock Exchange proposal could have a substantial impact on the regional exchanges. A primary method by which regional exchanges have competed for the portfolio business of institutions has been to offer institutional managers a more flexible rate structure than that of the New York Stock Exchange, *i.e.*, by permitting give-ups to a wider category of persons. Regional exchanges rely heavily on reciprocal business patterns which permit their sole members (nonmembers of the New York Stock Exchange) to obtain indirect access to the New York Stock Exchange. In this connection regional exchange rules facilitate reciprocal business practices by which dual members (members of the New York Stock Exchange and a regional exchange) compensate members of regional exchanges for business executed on the New York Stock Exchange. The New York Stock Exchange

[4] Special Study, *supra*, 301, 318.
[5] Mutual Fund Report, Chapter 4, pp. 162-188.
[6] Mutual Fund Report, Chapter 4, pp. 185-186.

proposal would curtail such practices. It also would prevent institutions from obtaining membership on regional exchanges or otherwise engaging in reciprocal business practices which, in effect, reduce the portfolio commissions such institutions pay. Both the impact and the significance of the Exchange proposal, insofar as it involves the regional exchanges, are affected by a change which has taken place in the primary function of the regional exchanges. These exchanges were originally conceived of as primarily providing local markets for local securities. With the passage of time, the emphasis on most of the regional exchanges has shifted to providing a local market for securities traded on the New York Stock Exchange. Technical improvements in communication and the development of over-the-counter markets for local securities have contributed importantly to this change in the nature of the regional exchanges. As pointed out above, in many instances the participation of certain regional exchanges amounts to no more than providing a location where privately negotiated "cross" transactions in New York Stock Exchange listed stocks are recorded and give-ups are distributed.

Finally, the New York Stock Exchange proposal permits the continuation of customer directed give-ups and would expand them to provide for give-ups to nonmember broker-dealers of the New York Stock Exchange on executions on that Exchange. It would also provide for minimum retentions by executing brokers. The justification for these restrictions presumably is that competition in liberality with respect to customer directed give-ups is not a desirable form of competition and that the economic health of the exchange community calls for a sharp and enforceable distinction between public customers and the brokerage industry.

Certain aspects of the New York Stock Exchange proposal are not specific, *i.e.*, the amount, kind, or applicability of the volume discount, the percentage of the minimum commission which a nonmember could receive and the qualifications which nonmembers would have to have in order to become eligible for this "access" and the amount of customer directed give-ups available to members and nonmembers, etc. Further, the Exchange proposal does not indicate whether the Exchange contemplates revision of the commission rate rules to relate commissions more directly to the money involved in a transaction rather than to the number of shares, thus modifying the existing disparity in commissions paid for a given investment in low priced stocks and in high priced stocks. This matter was discussed in a report to the exchange community from Mr. G. Keith Funston, then president of the Exchange, on July 21, 1967. Revisions along this line, as suggested by Mr. Funston, would not only modify this disparity but might provide a convenient way of introducing the proposed volume discount.

The Exchange apparently is initially concerned with the principles and objectives underlying its proposal. In this connection, the Commission assumes that if these principles and objectives are accepted, the Exchange will determine the specifics, *i.e.*, the dollar amounts, the percentages and the definitions, in such a way that the proposal will accomplish its intended purpose. Thus, for example, nonmembers would be offered a sufficient participation in commissions to induce them to bring their orders to the Exchange. The Commission understands that New York Stock Exchange members would be required to retain approximately 50 percent of the commission on any order with the balance available for customer directed give-ups.

The Commission believes that it is possible and appropriate for interested persons to express their views on the principles underlying the Exchange's proposal and the means by which its objectives may be accomplished even though, in the absence of more specific proposals, it may not be possible to determine the specific financial impact of various parts of the proposal on the earnings of various members and nonmembers or on the amount of commissions which institutional investors would pay.

PROPOSED COMMISSION RULE 10b-10

Proposed Rule 10b-10 represents an approach to the give-up problem which would not require significant change in the existing commission rate structure of exchanges nor require all exchanges to adopt a uniform approach to the question of give-ups and reciprocal business.

The Commission recognizes that the proposed rule is not a substitute for full reexamination of the structure and rates of commissions on the national securities exchanges. The proposed rule was under consideration prior to the announcement of the New York Stock Exchange proposal and has its antecedents in the Commission's Report on Investment Company Growth, which stated at p. 173:

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"It would not be inconsistent with [the] rules [of certain regional stock exchanges] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the fund."[6]

[6] Alternatively, the fund itself could form a broker-dealer affiliate to which it could direct give-ups. If this course were followed—and no fund now does so—the give-ups would inure to the direct benefit of the fund's shareholders."

The reasoning on which the proposed rule is based is that if, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so. Furthermore, diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of, Section 17(e)(1) of the Investment Company Act.[7]

The proposed rule therefore reflects a duty on the part of mutual fund managers as fiduciaries not to use commissions paid by their beneficiaries for the benefit of the fiduciary when practices, procedures, and rules of the markets in which such fiduciaries act permit their beneficiaries to receive tangible benefits in the form of reduction of the charges now borne by them. The proposed rule is bottomed on the premise that when a fiduciary uses commissions to obtain benefits for himself under these circumstances, his conduct would appear to violate applicable antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 as well as Section 17(e) of the Investment Company Act, particularly in view of the obscure and often devious ways in which this is accomplished. The proposed rule would be adopted pursuant to Sections 10(b) and 15(c)(1) and (2) and 23(a) of the Securities Exchange Act of 1934, Sections 206(4) and 211(a) of the Investment Advisers Act of 1940 and Sections 17(e) and 38(a) of the Investment Company Act.

The proposed rule would not impair the competition which now exists among brokers and among exchanges for the business of institutional customers by offering these customers substantial savings on commissions. On the contrary, the proposed rule recognizes that, as mentioned above, developments and competitive forces in the securities markets have, as an economic matter, tended to eliminate the existence of a fixed minimum commission rate on institutional orders.

The proposed rule would read as follows: • • • [reproduced on page 5, CCH.] • • •

While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach. Insofar as the New York Stock Exchange proposal would provide institutional investors with a volume discount while at the same time closing, insofar as possible, the various avenues by which an institutional manager can recoup commissions for the benefit of the fund, it could, depending upon the nature and extent of the volume discount, provide a direct rather than an indirect means by which institutional investors may obtain the benefit of lower charges. To the extent that it would make impossible indirect recoupment of commissions by institutional managers, the question of a fiduciary duty on their part to seek such recoupment would not arise.

All interested persons are invited to submit their views and comments on proposed Rule 10b-10 in writing to the Secretary, Securities and Exchange Commission, at its principal office, 500 North Capitol Street, Washington, D. C. 20549, on or before March 1, 1968.[8] The Commission also invites comments on the New York Stock Exchange proposal which is set forth in the attachment of this release, as well as any alternative suggestions for dealing with the problems presented. Material submitted will be made available for public inspection unless request for confidential treatment is made.

By the Commission.

Attachment

[7] The Commission does not believe that investment company directors may properly view the benefits derived by fund managers from give-ups as simply an additional form of compensation for investment management. Not only may this run afoul of Section 17(e)(1) of the Investment Company Act but the benefits derived by investment company managers from this source cannot be precisely or adequately disclosed in the prospectus, or in the investment advisory contract, as is required by Section 15(a)(1) of the Investment Company Act.

[8] The Commission has extended the due date for comments to April 1, 1968. Release No. 34-8261. CCH.

#237

PLAINTIFF'S EXHIBIT 120.

Report to the Directors of Chemical Fund, Inc.

of the

Subcommittee to Review Operations of the Fund and the Manager and Distributor

Performance

The performance of the Fund during 1968 was not impressive by most standards of comparison and materially below the longer-term record. However, the markets of the past year were not favorable for the type of growth stocks in which the Fund's assets are concentrated. Few portfolios invested in seasoned growth issues of good quality did appreciably better.

We believe that the most recent year's performance can be considered satisfactory under the circumstances and not inconsistent with the successful history of the Fund. Such periods have occurred in the past and no doubt will occur again in the future. It would be unreasonable and unwise to draw conclusions solely from a single year's experience, especially in light of the long-term record. Accordingly, on the basis of the high quality of investment management, we recommend renewal of the management agreement.

Management Fee

The scale of the management fee, good control over other expenses, and efficient operation of the Fund combine to produce a relatively low expense ratio. The present fee scale represents, in our opinion, an entirely satisfactory basis on which to renew the management agreement. It is profitable, as it should be, to the manager and affords a margin for the increased salary expenses for analytical staff which are inevitable in the present market.

Distribution

During the year 1968, repurchases exceeded sales of shares by approximately $1,800,000; however, in addition to normal sales, capital gains reinvested amounted to $22,100,000.

Although some other well established quality growth funds with assets of over $500,000,000 had even larger net redemptions, we can only characterize the distribution of Chemical Fund shares as disappointing. While 1968 was a record year of sales for the mutual fund industry, such sales were heavily dominated by relatively new funds aiming for quick performance. The question of making any changes in present distribution arrangements is, however, one which requires careful study and extensive discussion. At this time, therefore, in the absence of clearly defined alternatives, we recommend renewal for another year of the distribution agreement.

PLAINTIFF'S EXHIBIT 120

We have again reviewed the basis on which brokerage commissions are allocated as outlined on page 8 of the Prospectus. We recommend no change in present practices. Since December 5, 1968, the use of give-ups for sales and research has been prohibited by the rules of the Stock Exchanges. Since that time the Manager has, after discussion with the Board, continued to direct the brokerage business in such a way as to obtain the best price and execution. However, in selecting such brokers the extent to which such brokers have sold shares of the Fund or have provided statistical and research information will continue to be important factors. We are informed that the Manager and Distributor in determining those brokers who are best qualified to execute portfolio orders sent a questionnaire to 86 brokers requesting information as to their ability to act as institutional brokers for the Fund. As a result of this questionnaire, 48 brokers are now being used from time to time for the execution of portfolio transactions. During 1968 total portfolio brokerage amounted to $501,604 of which $430,150 was allocated for sales and $45,967 for research and statistical information.

We also recommend continuation of the practice of not executing any orders through the firm of F. Eberstadt & Co. which is a member of the New York Stock Exchange and the parent of the Manager and Distributor even though we recognize that it would be possible to request the Manager to execute some portfolio transactions through its parent as a member of the New York Stock Exchange or request give-ups on portfolio transactions which would be credited against the amount of the management fee.

We recommend that the entire approach to the distribution of shares be made the subject of early and detailed analysis, including among other alternatives, conversion to a no-load basis.

Burt N. Dorsett

Roger F. Murray

Burt N. Dorsett
Roger F. Murray

PLAINTIFF'S EXHIBIT 121.

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of the

Subcommittee to Review the Management and Distribution Agreements

#238

Your subcommittee has reviewed all aspects of the present agreements with the Manager and Distributor and recommends their approval substantially in the form being submitted to stockholders as shown in the January 21, 1970 proof of the proxy statement sent to each director. Our recommendations regarding the new fee scale are fully reflected in that document. Our specific comments on different aspects of the operations of the Fund and of the Manager and Distributor are given below.

Performance

We have studied the performance of Chemical Fund on the basis of (1) data compiled by Laird, Inc. and (2) an independent analysis completed by members of Dr. Murray's staff for the twelve years 1957 through 1968. For comparison, we have used eight large and well established mutual funds having growth as their primary investment objective. The results of the Laird data are as follows:

	Net Assets 9/30/69 (Millions)	% Increase in Net Assets per Share (a) 1 Yr. to 12/31/69	6 Yrs. to 12/31/69	11 Yrs. to 12/31/69
Chemical Fund	$ 532.0	4.2	84.4	152.7
National Investors	785.3	2.5	77.3	150.4
T. Rowe Price Growth	556.9	1.9	77.5	154.0
Mass. Inv. Growth	1,201.1	- 1.1	69.3	127.6
Technology Fund	629.7	-11.1	60.8	97.0
United Science Fund	434.2	-12.0	50.2	87.7
Dreyfus Fund	2,397.6	-12.8	66.8	163.1
Anchor Growth (b)	534.0	-17.4	87.4	123.9
Keystone Growth (K-2)	297.7	-27.7	63.9	110.5
Lipper Growth Stock Fund Index		-13.5	N.A.	N.A.
Dow-Jones Industrials		-15.2	4.9	37.1
Standard & Poor's 500 Stocks		-11.4	22.7	66.7
Standard & Poor's 425 Industrials		-10.2	28.0	72.1

Notes: (a) Adjusted for reinvestment of capital gain distributions
(b) Name recently changed from Diversified Growth

Within this group of well managed growth stock funds, then, Chemical Fund was first in net asset growth for 1969, second for the six years ended last December 31, and third for the longer period of eleven years. The record of performance is, of course, very substantially better than that of the "market" as measured by the conventional indexes.

The above comparisons, as compiled by Laird, Inc., are only a crude measure of performance. A more meaningful calculation would be the return earned by the fund with account taken of the risks incurred in the portfolio. The approach currently in use for this purpose is to calculate the average return earned by the

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fund in excess of the pure interest rate as represented by the U. S. Treasury bill yield and the volatility of that net return as measured by its standard deviation.

For example, the mean quarterly return of the S&P 500 Stock Index for the twelve years 1957 through 1968 was 1.74% in excess of the bill rate and the standard deviation was 6.8%. Chemical Fund had a mean quarterly excess return of 2.55%; but it assumed a higher risk than the market as indicated by the greater volatility of that return which had a standard deviation of 8.3%. At the Chemical Fund level of risk (volatility) a calculated market equivalent return would be 2.12%. A measure of the efficiency of Chemical Fund management would be the excess of the total net return of 2.55% over the "expected" or "risk adjusted" return of 2.12%, or 0.43%. This compares with the results of the other funds as follows:

	Difference
Dreyfus Fund	1.16%
Chemical Fund	0.43
National Investors	0.36
T. Rowe Price Growth	0.27
Technology Fund	0.26
Diversified Growth	0.20
Mass. Inv. Growth	0.03
Keystone Growth (K-2)	-0.10
United Science Fund	-0.33

Without going into an explanation of either their calculation or precise meaning, it is possible to say that other measures of portfolio efficiency show similar results. A normalized Sharpe Index ranks Chemical Fund at 1.21 behind the Dreyfus Fund's 1.59 and just ahead of National Investors' 1.18 and T. Rowe Price's 1.15. Another way measure for this period 1957-1968, which is designed to measure the quality of stock selections, is known as the intercept of the characteristic line. On this measure of management, Chemical Fund ranked as follows:

	Intercept
Dreyfus Fund	1.33
Diversified Growth	0.64
Chemical Fund	0.59
National Investors	0.50
Technology Fund	0.45
T. Rowe Price Growth	0.41
Mass. Inv. Growth	0.16
Keystone Growth (K-2)	0.11
United Science Fund	-0.14

The conclusion that Chemical Fund is a well managed, efficient portfolio emerges from these studies made for a different purpose by Dr. Murray's staff. They confirm the published results of a very careful analysis by Professor Michael C. Jensen, covering the ten-year period 1955-1964. His performance measure ranked Chemical Fund seventh in a group of 115 funds.* The comparable funds ranked as follows:

*Michael C. Jensen, "Risk, The Pricing of Capital Assets, and the Evaluation of Investment Portfolios," The Journal of Business, vol. 42, pp. 167-247 (April 1969).

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	Rank Among 115 Funds
Dreyfus Fund	2
Chemical Fund	7
T. Rowe Price Growth	11
National Investors	21
Mass. Inv. Growth	56
Technology Fund	83
Diversified Growth	90
United Science Fund	94
Keystone Growth (K-2)	106

Although these several measures cover only periods through 1968 or earlier, it is evident that if their extension through 1969 were possible at this date the ranking of Chemical Fund could only rise. Thus, we can fairly state that by objective tests the performance of Chemical Fund has been consistently on a par with the best managed growth stock mutual funds.

(Dr. Murray insists upon adding that the performance would have been even better if the emphasis on scientific and research oriented businesses had been even greater relative to investments in portfolio companies in which natural resources or manufacturing processes are the critical variables. He expects that the new focus on interscience will enlarge the commitment of research time by the Manager's staff to exploring the fruits of scientific developments.)

Management Fee

The explosive increase in costs in recent years has been particularly evident in the field of investment management. Increased emphasis on performance has created a seller's market for capable analysts. Meanwhile, other operating expenses of the manager have also risen and will continue to do so, especially when the present lease for office space expires.

We are disturbed that the growth of the Fund and its excellent performance have not been commensurately rewarding to those responsible for the direction of the managerial function. The new fee scale which the Board has approved does not guarantee a high level of profitability but provides a profit incentive for continuation on a sustained basis of superior performance. Indeed, if performance persistently lags, the Manager will receive lower compensation than at present.

Under the proposed incentive fee and after other expense allocation adjustments, the ratio of expenses to net assets would have been 0.526% for Chemical Fund in 1969. This compares as follows with the expense ratios of the other leading growth stock funds:

Dreyfus Fund	0.55%
National Investors	0.18
T. Rowe Price Growth	0.52
Technology Fund	0.56
Diversified Growth (Anchor)	0.61
Mass. Inv. Growth	0.31
Keystone Growth (K-2)	0.53
United Science Fund	0.37

Note: If Chemical Fund were as large as Dreyfus Fund, its expense ratio would

be 0.478% as a result only of the tapering of the management fee at the maximum incentive rate. Several of the other funds share expenses and this in part accounts for lower expense ratios.

The new fee, even at the maximum performance rate, is not out of line with other funds. It must be kept constantly in mind, moreover, that the 0.526% expense ratio is contingent on a three-year excess of more than fifteen percentage points over the S&P 425 Industrial Stock Index.

Distribution

During 1969, sales increased some 7.5% over 1968 totals to approximately the level of 1967 when the market environment was more favorable. Sales exceeded repurchases by approximately 153,000 shares and $2,956,000 in contrast with the negative cash flow of $1,800,000 in 1968 from sales and repurchases. This modest improvement is encouraging. The further steps of appointing a new national sales manager and four new wholesalers reflect an effort to follow through on the Fund's 1969 performance record.

We believe that it is reasonable to await the results of these steps with patience and accordingly have recommended renewal of the distribution agreement for another year.

Allocation of Brokerage Commissions

The prohibition of give-ups in December 1968 eliminated one aspect of the commission allocation question. The modest reduction in the commission scale to take account of larger transactions apparently contributed to the lower volume of such fees in 1969. While the turnover rate rose from 5.3% in 1968 to 10.3% in 1969, the total commissions paid declined from $501,604 to $472,771. Allocations for statistical and investment information were about the same, at the $46,000 level in both years, and seem relatively low. We recommend that the Manager give consideration to the allocation of a larger volume of commissions for investment research, particularly during the current broadening of the interscience concept of investment media.

In general, however, we believe that the Manager should continue to allocate brokerage commissions among firms qualified to provide good execution service and also effective in the distribution of Fund shares. It is in the stockholders' interest to assure a continuing flow of new sales to offset the inevitable repurchases in a fund now almost 32 years old and therefore subject to liquidations at death, etc.

In principle, we favor continuation of the practice of not placing New York Stock Exchange orders through the member firm of F. Eberstadt & Co., Inc., parent of the Manager. It is our understanding that no change in this practice will be made without the specific concurrence of a majority of the unaffiliated directors of Chemical Fund. We believe that this should be the only restriction on the complete discretion of the Manager and Distributor to allocate brokerage commissions.

Respectfully submitted,

Burt N. Dorsett

Roger F. Murray

January 22, 1970

#239

PLAINTIFF'S EXHIBIT 122.

Memorandum for the Board of Directors of Chemical Fund, Inc.

We have reviewed the operations of Chemical Fund and F. Eberstadt & Co., Managers & Distributors, Inc. in connection with the renewal and revision of the management and distribution agreements. We shall not repeat the general considerations discussed in prior years, but note that they still apply.

Performance

For the year 1970, Chemical Fund's performance did not compare favorably with the widely used market averages. This was also true of mutual funds in general and especially true of growth stock funds. In part, this reflects the fact that growth stocks held up well in the early phases of the 1969-1970 bear market, with most of the serious decline in prices occurring in 1970. It is necessary to review performance during 1968, 1969, and 1970, therefore, in order to interpret 1970 results.

The data which follow include comparisons with three high quality growth stock funds whose objectives are similar to those of Chemical Fund:

	Total Return			
	1968	1969	1970	1968/1970
Chemical Fund	6.38%	5.88%	-6.42%	5.42%
Mass. Inv. growth	1.08	0.16	-6.38	-4.60
National Investors	8.15	4.34	-9.00	2.69
T. Rowe Price growth	8.40	3.48	-7.81	3.42
8 growth Funds (a)	12.88	-12.00	-7.14	-6.01
11 growth Funds (b)	7.10	-9.07	-6.85	-9.29
Median for all Funds	15.55	-13.89	-6.13	-1.01
Dow Jones Industrials(c)	4.27	-15.19	4.82	-7.31
S&P 425 Industrials (c)	7.53	-10.20	-0.58	-4.01
NYSE Composite (c)	9.42	-12.51	-2.52	-6.00

Source: Arthur Lipper Corp. Mutual Fund Performance Analysis

Notes: (a) Funds having assets between $250 and $500 million on 9/30/70
(b) Funds having assets in excess of $500 million on 9/30/70.
(c) Returns for these averages do not include reinvestment of income dividends. The understatement of total return is roughly 3 percent per annum.

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For the three years, 1968-1970, Chemical Fund's performance ranked 101 out of 307. In 1970, it was 237 out of 463. Other comparable funds ranked as follows:

	1968/70	1970
Mass. Inv. Growth	171	236
National Investors	127	271
T. Rowe Price Growth	119	255

Source: Arthur Lipper Corp. Mutual Fund Performance Analysis

These comparisons suggest that results have been eminently satisfactory in a difficult period. They are consistent with the superior performance results of Chemical Fund over a long period of years, confirming the quality of management and the validity of the Fund's basic concept of seeking "growth in capital and income by investing in companies whose business is in the world of chemical science, research, and technology."

Incentive Compensation

We believe that the shareholders' interests are well served by a management fee which reflects actual investment performance over a 36-month period. We believe that the fee schedule which became effective on April 1, 1970 met this objective fairly and equitably. However, the Investment Company Amendments Act of 1970 requires that any increase or decrease from the basic fee be equally proportionate to positive or negative variations from average performance, ~~as measured by the S&P 425 Industrial Stock Index~~.

We conclude that the proposed basis is also fair and equitable and recommend the revised schedule without reservation. It is essential that the profit incentive be employed to secure the best long-term results for shareholders. The inflationary rise in costs had severely eroded this incentive prior to the action taken a year ago. The new management fee arrangement will make Chemical Fund, based upon our analysis of the operating results of M.&D., a profit center consistent with the investment management responsibilities involved.

We have also compared the projected expense ratio with those for other well managed funds of similar size. It is approximately in line with other such ratios. It will be above average only if the results are significantly above average. This is as it should be, in our judgment.

Allocation of Brokerage

We recommend no change at this time in the method of directing brokerage business. Because of the relatively low rate of portfolio turnover (only 12.1 percent in 1970), the volume of commissions paid is small for a fund of Chemical Fund's size (only some $650,000 in 1970).

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With so many proposals under discussion regarding negotiated commission rates, institutional membership, and the possibility of "unbundling", we believe that it would be unwise to alter present arrangements. We recommend, however, that the subject be reviewed promptly in light of any developments during the year.

Distribution

The material improvement in sales during 1970 is noted with satisfaction. The results for recent years are as follows:

	Amounts in Millions	
Year	Sales*	Redemptions
1970	$37.2	$22.4
1969	24.6	20.3
1968	22.9	23.2

*Excluding reinvestment of capital gain distributions.

In view of this recent progress in maintaining the vitality of the Fund, we believe that no change in the distribution agreement is appropriate at this time. We note, however, that the distribution function still produces an operating loss for M&D. We also note that T. Rowe Price Growth Stock Fund, a no-load fund with no better recent record, showed a superior record of net sales.

Since possible changes in the commission structure could affect competitive conditions in the sale of fund shares, we recommend that the entire question of the best distribution method for Chemical Fund shares be reviewed again not later than at the September board meeting.

Respectfully submitted,

Alfred E. Driscoll

Roger F. Murray

February 17, 1971

PLAINTIFF'S EXHIBIT 123.

Memorandum for the Board of Directors of Chemical Fund, Inc. #240

The purpose of this memorandum is to record the conclusions reported verbally by the subcommittee of disinterested directors at the January 19 Board Meeting. This memornadum also includes some background material on performance not previously presented to the Board because it was only subsequently made available from the term paper prepared by a student in Professor Murray's portfolio management seminar.

Performance

The year 1971 was a materially better year for Chemical Fund's performance than 1970 when compared with market indexes. The record was not impressive, however, when compared with the three other high-quality growth stock funds to which Chemical Fund is most similar in investment objectives. The less favorable results in the most recent period may reflect inclusion in the portfolio of investments in American Tel. & Tel. or other more slowly growing companies during a major portion of the year.

Based upon the Arthur Lipper Mutual Fund Performance Analysis, the results on a total return basis for one, three, and five years are as follows:

	Total Return		
	1/1/71 to 12/31/71	1/1/69 to 12/31/71	1/1/67 to 12/31/71
Chemical Fund	20.95%	20.04%	66.82%
Mass. Inv. Growth	23.20	15.55	51.54
National Investors	28.12	21.66	73.03
T. Rowe Price Growth	31.87	25.81	73.09
15 Growth Funds (a)	20.53	3.67	50.90
S & P 425 Industrials (b)	11.72	- 0.27	32.24

(a) Funds having assets in excess of $500 million on 9/30/71 including the above four funds.
(b) Change in price only; not total return, which would be about 3 per cent per annum higher.

The Lipper ranking of 526 funds for 1971 and 279 for the five years 1967/71 showed the following results:

	1971	1967/71
Chemical Fund	176	52
Mass. Inv. Growth	141	109
National Investors	88	37
T. Rowe Price Growth	51	35

These comparisons suggest that Chemical Fund's performance, excellent in the difficult years 1969-1970 compared with other growth funds, became relatively less impressive only when market prices showed a substantial improvement. This is another way of saying that the beta coefficient for the Chemical Fund portfolio is significantly less than 1.0, apparently lower than it was in prior years.

The following comparison for the years 1961-1970 provides an analysis of Chemical Fund's performance in somewhat greater detail over a longer period of time:

High Quality Growth Funds	Total Return	Alpha	Beta	Risk Index
Chemical Fund	10.95%	2.39	0.94	1.11
Mass. Inv. Growth	8.79	0.54	0.91	1.07
National Investors	9.30	1.30	0.88	1.03
T. Rowe Price Growth	9.77	2.06	0.85	0.99
Other Large Funds				
Dreyfus	10.50%	0.99	1.04	1.17
Enterprise	26.11	1.40	2.65	3.47
Fidelity Capital	13.56	1.24	1.35	1.66
Keystone S-4	10.15	-5.20	1.68	1.99
Oppenheimer	15.91	2.21	1.50	1.65
Putnam Growth	10.39	-1.85	1.34	1.50
United Science	7.24	-2.89	1.11	1.31
Windsor	11.16	1.34	1.08	1.26

Note: None of the alphas is statistically significant; all of the betas are. The risk index is the ratio of the standard deviation of the fund's average return divided by the standard deviation of the market's average return. This index in our opinion is a better measure of the risk or variability characteristics of the various portfolios than the beta coefficient, but is less widely used.

PLAINTIFF'S EXHIBIT 123

In this longer view of Chemical Fund's performance, the evidence of efficiency is highly persuasive. The achievement of relatively good returns with relatively low risk reflects favorably on the selection of individual issues and the basic concept of the Fund to invest "in a wide range of scientifically oriented companies.... where chemistry, chemical processes or other sciences interrelated with chemistry play an important role."

Incentive Compensation

As previously discussed, we believe that the present incentive compensation and the method of computing it are in the best interests of shareholders in that they provide a reward for superior results over a three-year period. We confirm our strong endorsement of the present terms of the management agreement.

We note that the expense ratio has risen in recent years because of (1) the substitution of cash fees for compensating balances in paying for certain services and (2) the increase in compensation to the manager designed to enhance the incentives and rewards for superior investment management. We believe that expenses are under good control despite rising costs in all aspects of the business. We also note that the expense ratio is not out of line with representative funds of comparable size.

Allocation of Brokerage

The present prospectus and the vote of shareholders at the Annual Meeting clearly state the position which we recommend on the matter of allocating brokerage. Since the position of the disinterested directors on handling brokerage has been stated and reaffirmed over the years, we have nothing to add at this time.

We have noted the careful review made by the Portfolio Committee of negotiated commissions. We believe that a record of diligence and good judgment has been clearly established. Considering the greater importance of obtaining a good execution, moreover, we see this whole question as being a very limited significance to the total results achieved for shareholders. Nevertheless, we recommend that the Portfolio Committee or the full Board continue to review negotiated commissions from time to time.

Distribution

The record of distribution of Chemical Fund shares continues to show improvement in the face of generally less favorable

industry trends.

	Amounts in Millions	
	Sales	Redemptions
1971	$ 54.8	$ 26.2
1970	37.2	22.4
1969	24.6	20.3
1968	22.9	23.2

With this excellent record and improvement in the resulting cash flow to the Fund, we have seen no reason to make any changes in the distribution agreement at this time.

Respectfully submitted,

James S. Coles

James S. Coles

Roger F. Murray

Roger F. Murray

March 27, 1972

/wh

#241

PLAINTIFF'S EXHIBIT 124.

January 15, 1973

REPORT TO THE UNAFFILIATED DIRECTORS OF THE CHEMICAL FUND IN REGARD TO THE RENEWAL OF THE MANAGEMENT AND DISTRIBUTION AGREEMENTS.

This memorandum summarizes the conclusions of the sub-committee of unaffiliated directors of the Chemical Fund regarding the renewal of the Management and Distribution Agreements of the Fund with F. Eberstadt and Co., Managers and Distributors, Inc. (M&D). We recommend renewal of these agreements for the ensuing year with the modifications from the present agreements as discussed below.

The Committee met on January 12 to review the materials which had been furnished to each member, to discuss with Messrs Porter and Williams the modifications of the incentive management fee arrangements, and to discuss the renewal of the agreements and other matters. Data were furnished to the Committee covering the performance of the Fund, the expense ratio of the Fund, the financial statements of M&D and the allocation of expenses of M&D between this Fund and the Eberstadt Fund, the sales records of the Fund, the handling of brokerage by M&D, draft changes of the Management Agreement, organization chart and background material on M&D personnel, and relevant comparative data with a selection of other leading funds. Initially we want to commend M&D for the completeness and usefulness of the material furnished.

We are all aware of the excellent performance record of the Fund and the equally excellent sales record. As to performance the Fund ranked among the top half-dozen during the calendar year 1972 and far outstripped the S&P 425 stock average, +29.3% as compared to +17.0%. Gross sales of shares during 1972 also reached a record high of $118 million, more than double the preceding year, and net sales amounted to $80 million, an increase of 180.4% over 1971. This latter figure is in sharp contrast to the net redemptions for the mutual fund industry as a whole. We also note the relatively low portfolio turnover of the Fund, and the fact that the expense ratio of the Fund is at about the average level of other leading funds. This latter level is despite the fact that many other Funds allocate brokerage internally and deduct such commissions from the management compensation. On all counts we believe the record of the Fund has been outstanding and we commend M&D in the highest terms. We urge the continuation of the basic policies which have led to such an outstanding record.

We also discussed the allocation of brokerage commissions. The directors of the Fund have discussed this matter at length during the past year and have established clear cut policies for M&D. We recommend no changes in these present procedures for the allocation of brokerage arising from portfolio transactions.

PLAINTIFF'S EXHIBIT 124

During the past year there have been several discussions with the SEC concerning the Incentive Management Fee used by the Fund. Unfortunately the SEC will not allow a continuation of the present arrangements, and recently has issued a set of rules relating to the method of calculating the incentive portion of a management fee. The Fund, consequently, has a choice of reverting back to a flat fee system of management compensation or to amend its arrangements to conform to the new SEC Rules. M&D has proposed a revised incentive fee system which conforms to the new SEC rules and this Committee recommends its adoption.

The proposed system involves five changes from the present arrangement:

1) The investment record of the Fund as compared to the S&P 425 Index must be calculated on the so-called "total return" concept which means the sum of a) the change in net asset value per share during the 12 quarters and b) the value of its cash distributions per share (both income and capital gains). The value of cash distribution of both the Fund and the Index are to be treated as reinvested in shares of the Fund or in the Index.

2) The basic fee will continue to be applied to the average daily net assets for the most recent quarter, but the incentive related portion of the fee must be applied to the average daily net assets for the 12 quarters used in the calculation of investment performance.

3) The percentage brackets or step rates of the incentive fee are to be altered to smooth out the changes between brackets to a constant ratio of 0.01% of fee for every two percentage points of superior or inferior performance.

In addition to these three changes required by the SEC, M&D also proposes:

4) A revision of the breakpoints of the basic fee applicable to levels of assets below $1 billion in order to establish a scale which can be applied to other funds under M&D's management. The scale has been designed so that the aggregate basic fee at the $1 billion asset level will equal approximately 0.35%, its current level, and

5) That the basic fee be paid monthly rather than quarterly.

The Committee concurs in these changes. It would have preferred to avoid the modifications involving the total return concept and level of assets to which the incentive fee is applicable, but it still believes that the proposed revision which continues an incentive arrangement is preferable to a return to a flat fee system.

PLAINTIFF'S EXHIBIT 124

Finally the Committee considered a proposal that the arrangement for directors fees be modified to incorporate an incentive arrangement parallel to the management fee system. This suggestion was discussed at length and the Committee recommended against the inauguration of such a system of incentive fees for directors. At the same time, the Committee noted that there had been no change in the level of directors fees for many years, and suggests that the level of such fees may well be revised upward to reflect changes in the economy and the contributions of the directors since the fee level was established. It has suggested to M&D that it make a study of the level of directors fees in comparable Funds and present the results to the Board at a later date.

Respectfully submitted:

Alfred E. Driscoll

Bertrand Fox

Auguste Richard

ARTICLE XV

Commissions and Service Charges

¶ 1701 Obligation To Charge or Collect Commissions

SEC. 1. Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of members or allied members or of parties not members or allied members of the Exchange, of securities admitted to dealings upon the Exchange and these commissions shall be at rates not less than the rates in this Article prescribed; and shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement direct or indirect. No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit except as may be specifically permitted by the Constitution or a rule adopted by the Board of Directors, shall be given, paid or allowed, directly or indirectly, or as a salary or portion of a salary, to a clerk or person for business sought or procured for any member or allied member of the Exchange or member firm or member corporation. No member, member firm or member corporation shall, in consideration of the receipt of listed business and at the direct or indirect request of a non-member or by direct or indirect arrangement with a non-member, make any payment or give up any work or give up all or any part of any commission or other property to which such member, member firm or member corporation is or will be entitled.

Commissions on other exchanges

Notwithstanding the provisions of this Article, any member of the Exchange or member firm or member corporation holding a membership or associate membership in another exchange located in the United States, or holding a membership or associate membership in a Canadian exchange, or registered with a Canadian exchange as being entitled to a return of commission from members of said exchange, may in respect of transactions made on such other exchange charge the rates of commission prescribed by such other exchange.

Amendments.
October 24, 1968, effective December 5, 1968.
Adopted March 1, 1972.

¶ 1702 Commissions on Stocks, Rights and Warrants

SEC. 2. STOCKS, RIGHTS AND WARRANTS (hereinafter referred to as "stocks")

Non-member rates

(a) On that portion of an order involving an amount of $300,000 or less, on business for non-members and allied members, including joint account transactions in which any such person is interested:

On 100 share orders

(1) On each order for 100 shares, commissions shall be based upon the amount involved in the order and shall not be less than the rates hereinafter specified:

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Amount Involved in the Order	*Minimum Commission*
Above $2,000—but under $2,500	1.3% of money involved + $12.00
$2,500—and above	0.9% of money involved + $22.00

Notwithstanding the foregoing:

(i) When the amount involved in an order is $2,000 or less, the minimum commission shall be as mutually agreed.

(ii) The minimum commission on an order for 100 shares shall not exceed $65.00.

Multiple round lot orders

(2) On each multiple round lot order for 200 shares or more, commissions shall be based upon the amount involved in the order and shall not be less than the rates hereinafter specified:

Amount Involved in the Order	*Minimum Commission*
Above $2,000—but under $2,500	1.3% of money involved + $ 12.00
$ 2,500—but under $ 20,000	0.9% of money involved + $ 22.00
$20,000—but under $ 30,000	0.6% of money involved + $ 82.00
$30,000—to and including $300,000	0.4% of money involved + $142.00

Plus a charge for each round lot of 100 shares within the order as follows:

First to tenth round lot	$6.0[illegible] lot
Eleventh round lot and above	$4.00 per round lot

Notwithstanding the foregoing:

(i) When the amount involved in an order is $2,000 or less, the minimum commission shall be as mutually agreed.

(ii) The minimum commission per round lot shall not exceed the single round lot commission computed in accordance with the provisions of paragraph 2(a)(1).

Odd lot orders

(3) On any odd lot order, commissions shall be based upon the amount involved in the order and shall not be less than the rates specified in paragraph 2(a)(1), less $2.00.

Notwithstanding the foregoing:

(i) When the amount involved in an odd lot order is $2,000 or less, the minimum commission shall be as mutually agreed.

(ii) The minimum commission on an odd lot order shall not exceed $65.00.

(iii) When one or more odd lot orders plus one or more round lot orders are executed in the same security, on the same day, for the same account, on the same side of the market, the commission(s) on such odd lot order(s) shall not exceed the commission which would be chargeable with respect to the nearest round lot in excess of such odd lot order(s).

(4) On that portion of an order involving an amount of $300,000 or less, on stocks selling below $1.00 per share, commissions shall be based

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upon the amount involved in the order and shall not be less than the rates hereinafter specified:

Amount Involved in the Order	*Minimum Commission*
Above $2,000—but under $10,000	5.0% of money involved + $ 34.00
$10,000—and above	4.0% of money involved + $134.00

Notwithstanding the foregoing, when the amount involved in an order is $2,000 or less, the commission shall be as mutually agreed.

(5) On any order involving an amount not in excess of $5,000, the commission computed in accordance with this paragraph 2(a) shall be increased by 10%. On any order involving an amount in excess of $5,000, the commission computed in accordance with this paragraph 2(a) shall be increased by 15%.

Intra-member rates for floor brokerage and clearance

(b) On that portion of an order involving an amount of $300,000 or less, on business for members of the Exchange when a principal is not given up, commissions shall be based on the number and price of shares in the order as follows:

	Number of Shares				
(1) Price per Share	First Hundred	Second Through Fifth Hundred	Sixth Through Tenth Hundred	Eleventh Through Fiftieth Hundred	Fifty-First And Above
Below 8/32 of $1.00	$0.20	$0.20	$0.10	$0.10	$0.10
8/32 of $1.00 and above, but under $1.00	1.00	1.00	0.90	0.80	0.70
$ 1 and above, but under $ 2	2.40	2.40	2.00	1.80	1.60
2 and above, but under 4	2.80	2.60	2.40	2.20	2.00
4 and above, but under 6	3.30	3.10	2.90	2.40	2.00
6 and above, but under 8	3.80	3.60	3.40	2.60	2.20
8 and above, but under 10	4.30	4.10	3.90	2.80	2.40
10 and above, but under 12	4.80	4.60	4.40	3.00	2.60
12 and above, but under 14	5.30	5.10	4.80	3.20	2.80
14 and above, but under 16	5.80	5.60	5.20	3.40	3.00
16 and above, but under 18	6.20	6.00	5.50	3.70	3.20
18 and above, but under 20	6.60	6.40	5.80	4.00	3.40
20 and above, but under 25	7.00	6.80	6.20	4.60	3.80
25 and above, but under 30	7.40	7.20	6.40	5.20	4.40
30 and above, but under 35	7.60	7.40	6.60	5.80	5.00
35 and above, but under 40	7.80	7.60	6.80	6.20	5.40
40 and above, but under 50	8.40	8.00	7.20	6.60	6.20
50 and above, but under 60	9.00	8.60	7.80	7.00	6.60
60 and above, but under 75	9.00	8.80	8.00	7.40	7.20
75 and above	9.00	9.00	9.00	8.20	8.00

(2) Notwithstanding the foregoing, when the amount involved in an order is less than $100, the commission shall be as mutually agreed.

Intra-member rates for floor brokerage

(c) On that portion of an order involving an amount of $300,000 or less, on business for members of the Exchange when a principal is given up, commission shall be based on the number and price of shares in the order as follows:

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(1) Price per Share	Number of Shares: First Hundred	Second Through Fifth Hundred	Sixth Through Tenth Hundred	Eleventh Through Fiftieth Hundred	Fifty-First And Above
Below 8/32 of $1.00	$0.10	$0.10	$0.05	$0.05	$0.05
8/32 of $1.00 and above, but under $1.00	0.50	0.50	0.45	0.40	0.35
$ 1 and above, but under $ 2	1.20	1.20	1.00	0.90	0.80
2 and above, but under 4	1.40	1.30	1.20	1.10	1.00
4 and above, but under 6	1.65	1.55	1.45	1.20	1.00
6 and above, but under 8	1.90	1.80	1.70	1.30	1.10
8 and above, but under 10	2.15	2.05	1.95	1.40	1.20
10 and above, but under 12	2.40	2.30	2.20	1.50	1.30
12 and above, but under 14	2.65	2.55	2.40	1.60	1.40
14 and above, but under 16	2.90	2.80	2.60	1.70	1.50
16 and above, but under 18	3.10	3.00	2.75	1.85	1.60
18 and above, but under 20	3.30	3.20	2.90	2.00	1.70
20 and above, but under 25	3.50	3.40	3.10	2.30	1.90
25 and above, but under 30	3.70	3.60	3.20	2.60	2.20
30 and above, but under 35	3.80	3.70	3.30	2.90	2.50
35 and above, but under 40	3.90	3.80	3.40	3.10	2.70
40 and above, but under 50	4.20	4.00	3.60	3.30	3.10
50 and above, but under 60	4.50	4.30	3.90	3.50	3.30
60 and above, but under 75	4.50	4.40	4.00	3.70	3.60
75 and above	4.50	4.50	4.50	4.10	4.00

(2) Notwithstanding the foregoing, when the amount involved in an order is less than $100, the commission shall be as mutually agreed.

Odd lots

(3) Notwithstanding the provisions of subsections (1), and (2) of this paragraph (c), the commission rate in stocks, when the amount dealt in is less than the unit of trading, shall be not less than 1¢ per share on stocks selling below $10 per share, and 2¢ per share on stocks selling at $10 per share or more.

Definition of an order

(d) For the purposes of this Section 2

(1) A round lot order shall be deemed to include all purchases or sales for one account, of a single security, on the same day, pursuant to a single order, amounting to 100 shares or any multiple thereof, irrespective of the unit of trading in the stock. This definition applies whether the order is received from a non-member, allied member, member, member firm or member corporation.

(2) An odd lot order shall be deemed to include all purchases or sales for one account, of a single security, on the same day pursuant to a single order, amounting to less than 100 shares, irrespective of the unit of trading in the stock. Any odd lot order shall be deemed to be a separate order whether combined with a round lot order or standing alone. This definition applies whether the order is received from a non-member, allied member, member, member firm or member corporation.

Determining amount involved in an order

(e) In determining the amount involved in an order, commissions and taxes shall be disregarded.

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(f) Notwithstanding the rates prescribed in paragraphs 2(a)(1) and 2(a)(2), when the amount involved in an order exceeds $300,000, the minimum commission to be charged pursuant to those paragraphs shall apply to the maximum number of round lot transactions involving an aggregate amount not in excess of $300,000. The Exchange shall from time to time prescribe the procedures to be followed in computing commissions pursuant to this Article.

Special rates

(g) Notwithstanding the rates prescribed elsewhere in this Section 2, the commission rates to members, allied members and non-members upon stocks which, pursuant to call or otherwise, are to be redeemed within twelve months shall be such rates as may be mutually agreed upon, provided, however, that such rates shall apply to transactions in any specific stock only after announcement to that effect has been made by the Exchange, and provided, further, that the Board of Directors may determine special rates on any or all such securities.

(h) A member, member firm or member corporation may, on orders which he or it receives from a nonmember broker which is a citizen of the United States or Canada or a partnership or a corporation created or organized under the laws of the United States or Canada, or any state or province thereof, which does not have as a parent any party other than a citizen of the United States or Canada or a corporation or a partnership created or organized under the laws of the United States or Canada, or any state or province thereof, whose principal place of business is in the United States or Canada, or any state or province thereof, and which is a member of the National Association of Securities Dealers, Inc. or is subject to Sec. 15(b)(8) of the Securities Exchange Act of 1934, for the account of any customer who is not an affiliated person of such nonmember broker within the meaning of the rules of the Board of Directors, whose account is carried by such nonmember broker or is introduced by such nonmember broker to such member, member firm or member corporation, allow not in excess of a 40% discount from the commission computed in accordance with the provisions of paragraph 2(a), provided that such nonmember broker is subject to an agreement in writing as provided by rule adopted by the Board of Directors, which agreement has not been terminated, containing such provisions as may be required from time to time by rule adopted by the Board of Directors and providing that any such discount so allowed shall be retained by such nonmember broker free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement, direct or indirect, to or for the benefit of any customer of such nonmember broker except that with respect to any order for the account of a customer whose account is introduced to such nonmember broker by a second nonmember broker, the nonmember broker may allow all or any portion of such discount to such second nonmember broker provided that the second nonmember broker would qualify for a discount under the provisions hereof had it introduced its customer's account directly to the member, member firm or member corporation and is itself subject to a similar agreement.

Amendments.

October 29, 1953, effective November 9, 1953.
April 3, 1958, effective May 1, 1958.
March 5, 1959, effective March 30, 1959.
October 24, 1968, effective December 5, 1968.
April 19, 1971.

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December 1, 1971.
March 24, 1972.
April 24, 1972.
April 19, 1973.
September 25, 1973.
March 20, 1974, effective April 1, 1974.

(See Rule 380 [¶ 2380] Special Commission Rates—Rights and Warrants Selling Below 50¢.)

¶ 1703 Commission on Bonds

SEC. 3. BONDS.

Non-member rates

(a) On business for non-members and allied members, including joint account transactions in which any such person is interested, the commission rates shall be not less than the following:

Price per $1,000 of Principal	*Rate per $1,000 of Principal*
Selling at less than $10	$ .75
Selling at $10 and above but under $100	1.25
Selling at $100 and above	2.50

Intra-member rates for floor brokerage and clearance

(b) On business for members of the Exchange when a principal is not given up, the commission rates shall be not less than the following:

Price per $1,000 of Principal	*Rate per $1,000 of Principal*
Selling at less than $10	$ .50
Selling at $10 and above but under $100	.62½
Selling at $100 and above	1.25

Intra-member rates for floor brokerage

(c) On business for members of the Exchange when a principal is given up, the commission rates shall be not less than the following:

Price per $1,000 of Principal	*Rate per $1,000 of Principal*
Selling at less than $10	$ .25
Selling at $10 and above but under $100	.37½
Selling at $100 and above	.75

Special rates

(d) Notwithstanding the foregoing, the commission rates to members, allied members or non-members upon obligations of the United States, Puerto Rico, Philippine Islands and States, Territories and Municipalities therein; upon obligations of any international authorities in which the United States is a participant; upon bonds or notes having five years or less to run; and upon bonds or notes which, pursuant to call or otherwise, are to be redeemed within twelve months, shall be subject to rates as may be mutually agreed upon; provided, however, that the Board of Directors may determine special rates on any or all such securities.

Amendment.
March 29, 1956.
March 7, 1963.

DEFENDANTS' EXHIBIT O.

For RELEASE Monday, November 10, 1969

SECURITIES AND EXCHANGE COMMISSION

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SECURITIES EXCHANGE ACT OF 1934
Release No. 8746

The Securities and Exchange Commission today released a letter written by Philip A. Loomis, Jr., its General Counsel, in response to an inquiry which had been received concerning certain aspects of the obligations of mutual fund managements and brokers with respect to commissions on portfolio brokerage of mutual funds. The letter is as follows:

"This is in reply to your letters in which you raise several significant questions concerning the obligations of mutual fund managements and brokers with respect to commission on portfolio brokerage of mutual funds. By 'mutual fund management,' I mean not only the officers and directors of the fund but also any investment adviser or management company which serves the fund.

"As you know, the Commission is conducting hearings and a study of exchange commission rates and the exchanges are also engaged in further reconsideration of this matter. Any conclusions expressed in this letter are naturally subject to modification in the light of these developments or further consideration by the Commission of the results of these studies.

"You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat, directly or through an affiliate, in order to utilize this means to recapture brokerag which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interest of the fund to create such an affiliate. Proposed Rule 10b-10, as published for comment on January 26, 1968, to which you refer, has been withdrawn.

"As you suggest, the statements in letters from the Commission to stock exchanges in connection with their adoption of rules abolishing the customer-directed give-up, that the Commission understood that these rules were not designed to terminate procedures whereby institutions may obtain returns of commissions merely reflected, in our view, that the exchange rules with respect to customer-directed give-ups did not, and were not intended to, terminate the existing arrangements which a few mutual fund organizations have made for the indirect recapture of a portion of their commissions. It is my understanding that this is not presently accomplished by means of customer-directed give-ups, which have been abolished, but in other ways, primarily by reciprocal practices. If these reciprocal practices are available to fund managements, it did not seem appropriate to foreclose their use to benefit the fund itself.

DEFENDANTS' EXHIBIT O

34-8746

"It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange whose rules permit the recapture of commissions paid by the fund through the use of that seat, there may be circumstances under which such recapture could be required and that the management may not be free to simply retain for itself revenues derived from this source. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers.

"You also inquire concerning the obligations of a broker who is aware that an affiliate of an investment company is participating in commissions attributable to transactions for that company in which the broker is also participating. Questions of this general nature are presented in certain administrative proceedings which are pending and of which you are aware. In view of this, I do not think it appropriate for me to discuss them at this time.

"In your letters you suggest various courses of action which the Commission might take with respect to the question of so-called 'institutional membership' and other aspects of the commission rate structure. Decisions on these matters will have to await further developments in the inquiries concerning the commission rate structure to which I referred earlier."

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United States Court of Appeals
For The Second Circuit

Susan Tannenbaum

Plaintiff-Appellant

against

Robert G. Zeller et al.

Defendants-Appellees

On appeal from the United States District Court
for the Southern District of New York

AFFIDAVIT
OF SERVICE

STATE OF NEW YORK,

COUNTY OF NEW YORK, ss:

Raymond J. Braddick, agent for Abraham J. BrillEsq. being duly sworn,

deposes and says that he is over the age of 21 years and resides at
8 Mill Lane Levittown, New York
That on the 17th. day of November , 1975

he served the annexed Brief for Plaintiff-Appellant and Appendix upon

1. Sullivan & Cromwell
Attorneys for Defendants-Appellees
F. Eberstadt & Co. Inc., F. Eberstadt & Co.

1. Sullivan & Cromwell
Attorneys for Defendants-Appellees
F. Eberstadt & Co. Inc., F. Eberstadt & Co.
Managers and Distributors Inc., and
Robert G. Zeller
48 Wall Street
New York, New York

2. Walsh & Frisch Esqs.
Attorneys for Defendant-Appellee
Chemical Fund Inc.,
250 Park Avenue
New York, New York

in this action, by delivering to and leaving with said attorneys

three true copies to each thereof.

DEPONENT FURTHER SAYS, that he knew the persons so served as aforesaid to be the persons mentioned and described in the said action.

Deponent is not a party to the action.

Sworn to before me, this 17th.

day of November, 1975

Roland W. Johnson

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 1977